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DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

REFORMING FEDERAL DEPOSIT INSURANCE, MODERNIZING THE REGULATION OF FINANCIAL SERVICES, AND MAINTAINING THE INTERNATIONAL COMPETITIVENESS OF U.S. FINANCIAL INSTITUTIONS

VOLUME III OF III

JULY 12, 19, 25, AND 31, 1990

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DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

VOLUME III OF III

THURSDAY, JULY 12, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 10:07 a.m., in room SD–538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Dixon, Graham, Wirth, Kerry, Bryan, Garn, Heinz, D'Amato, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The **CHAIRMAN**. The committee will come to order. Let me welcome all those in attendance this morning. Before we begin the hearing, I want to announce for the record, that as members arrive, they'll be recording their votes on favorably reporting the nomination of Andrew Hove to be a member of the Board of Directors of the FDIC for a term expiring February 28, 1993, and to be Vice Chairperson of the FDIC, and for Mr. Joseph Schiff to be an Assistant Secretary of the Department of Housing and Urban Development.

We'll begin the period for voting now and it will extend until the hearing concludes. If a quorum is established in that time, and I certainly hope it will be, the final vote will be announced as we adjourn and the nominations will be reported to the full Senate later today. And I want to be recorded in the affirmative on both nominations, and Senator Garn?

Senator **GARN**. Aye, aye.

The **CHAIRMAN**. Senator D'Amato.

Senator **D'AMATO**. Aye.

The **CHAIRMAN**. We will proceed in that fashion. Now with respect to our hearing today, we're very pleased to have the distinguished Chairman of the Federal Reserve, Alan Greenspan, with us here at this very important topic. This is the tenth of thirteen hearings this year on reforming Federal deposit insurance and modernizing our financial system.

In the previous hearings we've had testimony from trade associations, consumer groups and independent experts. Starting today the committee will hear from the Federal agencies involved. Our witness this morning is Alan Greenspan, Chairman of the Federal

Reserve Board. We will hear later this month from Treasury Secretary Brady, from FDIC Chairman Seidman, Comptroller Clark and SEC Chairman Breeden.

We asked Chairman Greenspan today to testify on the following questions: first, how should the current system of federal deposit insurance be reformed? Second, what should be done to improve the current regulatory structure? And, third, should new powers be granted to banks or their affiliates and, if so, what powers should be granted and what protections established for the deposit insurance fund?

In his written statement, Chairman Greenspan notes that Federal deposit insurance has enabled banks to lower their capital, grow aggressively and take excessive risks. So he recommends that banks should substantially increase their capital. He also indicates that risk to the deposit insurance fund would diminish is regulators took prompt and firm corrective action such as restricting dividends and asset growth when banks first get into trouble and that no bank is too large for such corrective action.

Chairman Greenspan also suggests the possibility of tying expanded powers to higher bank capital levels and reports that the Federal Reserve Board is reconsidering its current fire wall restrictions on securities affiliates of bank holding companies.

We welcome him here today. Before yielding to Senator Garn, let me just add another thought on this. We have been deciding what kind of financial modernization changes, structure and regulatory changes, may be appropriate, particularly in light of the rapid change in the global economy and Europe 1992. We have had important international witnesses testify on how our system can effectively interface with the international banking and financial system.

We not only need your expertise, but also your sense of the urgency of these questions within the next 12 to 18 months. It seems to me that for the remainder of this legislative year, we should prepare for major revision or restructuring of the financial services industry and its regulatory structure to occur in the 1991 in legislative year.

For this to happen, there has to be a clear consensus among the executive branch, the regulatory agencies, the Congress, and outside interested parties on what needs to be done. We are preparing ourselves to this task within that timeframe.

When the Bush administration sets its priorities for 1991 it will probably choose four, five, six key domestic policy items for its agenda. The list may be even smaller. This question needs to be one of the items on that short list if we are to do our work in an orderly way.

So I would like your answers to the questions we posed in your letter of invitation and also your sense of timing, to allow us to deal with these issues in that timeframe. Let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator Garn. Thank you, Mr. Chairman. It's always a pleasure to welcome the Chairman of the Federal Reserve Board as a witness before our committee. At the very least, you always guarantee us a very large audience, Mr. Chairman, so we have lots of witnesses here.

There's no question, there is enormous reason for all of us to be interested in the views of the Chairman of the Federal Reserve Board on the need to modernize our financial system. The Federal Reserve, the nation's monetary regulator, occupies a central place in that system. Chairman Greenspan adds to this role his own personal wealth of experience in many aspects of the financial services industries.

It is far from being a secret that I am an advocate for system-wide restructuring of the laws and regulations governing our financial services. During the 6 years I had the privilege as serving as Chairman of this committee, I urged coordinated and thorough modernization of these industries and strenuously fought efforts at piecemeal reform.

I thought then that successful reform could only be achieved on a comprehensive basis. So far we have yet to achieve any satisfactory degree of financial modernization. We have, however, achieved a growing recognition that the status quo is harmful, harmful to everyone concerned. Perhaps the onrush of change associated with Europe 1992 has been helpful.

I personally was struck by the testimony the committee received recently from the representative of Fuji Bank to the competitive challenge posed by Europe 1992, he added the likelihood of Japan 1992, the removal of barriers separating commercial banking and investment banking in Japan by the end of that year. We cannot afford to ignore these challenges.

In this process there is a role for everyone. Legislative changes, of course, will be required. Regulatory changes are necessary as well. Some of these have already been made and other action must be done by Congress.

Additional steps might be possible before 1992. I would remind us all of the catalytic role played by the Basle accord in achieving coordinated, global modernization of bank capital requirements. I would welcome a similar international effort in the area of securities market regulation.

So I think the time for studies is drawing to an end. The time for action may at least be arriving, not the time when action is needed, because in this Senator's opinion, that time is long past, but when action is unavoidable. And I think that's terribly unfortunate, because I can remember a decade ago making speeches that if Congress and regulators did not act, the changes would occur—and unfortunately they have—in a piecemeal fashion with the regulators, with the courts, with State legislatures, with foreign governments, as I've mentioned, Europe 1992.

So the time is long past due, but I hope finally there will be an awakening where people really do recognize that we need a modernized financial system in this country if we are going to be competitive, not only domestically, but internationally as well. So I do at least welcome the heightened awareness of the need for comprehensive financial modernization. Hopefully it will not be too long in coming.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman. Mr. Chairman, I have no opening statement.

And make one reference to Chairman Greenspan's testimony. I am interested in his positions as it relates to firewalls and the fact that he indicates that they're looking at this in certain synergies that might be available would be precluded.

By the same token, this Senator is very much concerned, and I've expressed this in the past, that if indeed they are not the kind of protections that will keep the deposit assets which are guaranteed by the FDIC and by the taxpayer insulated, that we're going to just see the same kinds of problems that we've experienced in the thrifts take place again in the commercial areas. And indeed I think that we may have some great problems on the way at the present time, if indeed certain economic conditions persist.

I would say there should be no firewalls whatsoever. I would say that let the banker do whatever he wants to commercial bank. If he wants to become involved in the securities area, let him do it. So be it, but with his own capital, with his own risk capital, and not being insured by the taxpayer of this country. And at some point in time, we've got to say, "Haven't we learned our lesson?"

That FDIC insurance was really basically there for the small depositor to insure that his life savings, and it used to be $10,000 and $40,000 and now $100,000, was going to be guaranteed. It wasn't there for the broker deposits, the guys that put it out. It wasn't there to guarantee all kinds of risks. It was for that small depositor, and I think it's been distorted.

And I think if there's not going to be firewalls then there'd better be strict regulations, and if you don't want strict regulations, certainly the Federal Government should not, Mr. Chairman, be in the business of guaranteeing these kinds of activities. And in essence that's what we're going to be doing.

So any financial modernization, if it does not, if we have not learned the lessons of the past, then shame on us. And I don't think we have. I think we have the big bankers just pushing and pushing. They want to get into every kind of activity and I absolutely do not believe that the Federal Government should be insuring these activities on the alter of saying that we're doing it for the taxpayer when we're not.

We shouldn't be in that business. If they want to go out and shoot crap, go to Las Vegas and do it. Let them do it, but don't let them do it with the taxpayer's underwriting their role. And that's exactly what's happening, and I think we ought to do something about that at the present time. I think we've got to look at that, Mr. Chairman.

And I'm interested in hearing our distinguished Chairman respond to that later on after he gives his testimony and focus in on this issue, because I think that's the issue of the day. Thank you, Mr. Chairman.

Senator GARN. Could I just make a comment. I agree with the Senator from New York, but I would remind him that every bill in the 15 years that I've been on this committee has done exactly that. As a matter of fact, additional powers were set up specifically in separate affiliates that were not even allowed to use the name of the bank, so there was total separation from depositors' money.

I don't know of any member of this committee since I've been here who has ever advocated these additional powers coming from insured deposits. So I certainly agree with the Senator from New York.

The CHAIRMAN. Thank you, Senator Garn. Chairman Greenspan, we'd be pleased to have you make your comments. We'll make your full statement a part of the record.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman GREENSPAN. Mr. Chairman, because of the nature of the subject matter, my opening remarks will be somewhat longer than usual.

Certainly. As usual, Mr. Chairman and members of the committee, I am delighted to be here to discuss any of a number of subjects, but especially to discuss reform of the deposit insurance system and expanded activities for banking organizations. The hearings you are conducting, Mr. Chairman, will establish a record preliminary to the publication early next year of the FIRREA—mandated Treasury study of the issues. The fundamental problems with deposit insurance that must be addressed are clearly understood. The safety net has lowered the risks perceived by depositors, and as a result they exercise insufficient discipline through the cost of deposits, dulling the incentive of some banks' owners to control risks. Profits associated with risk-taking accrue to owners, while losses in excess of bank capital that would otherwise fall on depositors are absorbed by the FDIC.

As a result, the implicit deposit insurance subsidy has encouraged banks to enhance their profitability by increasing their reliance on deposits rather than capital to fund their assets. It is difficult to believe that many of the banks operating over recent decades would have been able to expand their assets so much, with so little additional investment by their owners, were it not for the depositors' perception that, despite the relatively small capital buffer, their risks were minimal.

In addition, Government assurances of the liquidity and availability of deposits have enabled some banks with declining capital ratios to fund a riskier asset portfolio at a lower cost and on a much larger scale, with governmental regulations and supervision, rather than market processes, the major constraint on risk-taking.

But in reviewing the deficiencies of the deposit insurance system, we should not lose sight of the contribution that it has made to macroeconomic stability. Deposit insurance has protected the economy from the risk of deposit runs, especially the risk of such runs spreading from bank-to-bank, disrupting credit and payment flows and the level of trade and commerce. There are thus important reasons to take care as we modify our deposit insurance system. Reform is required. So is caution. The ideal is an institutional framework that, to the extent possible, induces banks both to hold more capital and to be managed as if there were no safety net, while at the same time shielding unsophisticated depositors and minimizing disruptions to credit and payment flows.

If we were starting from scratch, the Federal Reserve Board believes it would be difficult to make the case that deposit insurance coverage should be as high as its current $100,000 level. However, it is clear that the 1980 increase in depositor protection has been in place long enough to be fully capitalized in the market value of depository institutions. A return to lower deposit insurance coverage—like any tightening of the safety net—would reduce insured depository market values and involve significant transition costs. This is why the granting of subsidies by the Congress should be considered so carefully. They not only distort the allocation of resources, but also are extremely difficult to eliminate, imposing substantial transition costs on the direct and indirect beneficiaries. For such reasons, the Board has concluded that should the Congress decide to lower deposit insurance limits, a meaningful transition period would be needed.

No matter what the Congress decides on deposit insurance limits, we must be cautious of our treatment of uninsured depositors. Such depositors should be expected to assess the quality of their bank deposits just as they are expected to evaluate any other financial asset they purchase. However, the clear response pattern of uninsured depositors to protect themselves, by withdrawing their deposits from a bank under pressure, raises the very real risk that in a stressful environment the flight to quality could precipitate wider financial market and payments distortions. These systemic effects could easily feed back to the real economy, suggesting that public policy should rely on other means as the primary mechanism to induce prudent bank policies.

The Board believes that the most promising approach is to reform both bank capital and supervisory policies. Both would be designed to reduce the value of the insurance subsidy. Neither would rule out either concurrent or subsequent additions to deposit insurance reform. In fact, higher capital, by reducing the need for, and thereby the value of, deposit insurance would make subsequent reform easier.

As a result of the safety net, too many banking organizations, in our judgment, have traveled too far down the road of operating with modest capital levels. It may well be necessary to retrace our steps and begin purposefully to move to capital requirements that would, over time, be more consistent with what the market would require if the safety net were more modest. The argument for more capital is strengthened by the necessity to provide banking organizations with a wider range of service options in an increasingly competitive world, and to avoid an extension of the taxpayers' obligation to even more institutions. Our international agreements under the Basle Accord permit us to do so.

There are three objectives of a higher capital requirement. First, higher capital would strengthen the incentives of bank owners and managers to evaluate more prudently the risks and benefits of portfolio choices because more of their money would be at risk. Second, higher capital levels would create a larger buffer between the mistakes of bank owners and managers and the need to draw on the deposit insurance fund. And, third, requiring higher capital imposes on bank managers an additional market test. They must convince investors that the expected returns justify the commitment of risk capital.

For many banks, raising significant new capital will be neither easy nor cheap. Maintaining return on equity will be more difficult, and those foreign banks that only adhere to the Basle minimums may be put in a somewhat better competitive position relative to some U.S. banks. Higher capital requirements also will tend to accelerate the move toward bank consolidation and slow bank asset growth. However, these concerns must be balanced against the increasing need for reform now, the difficulties with all the other options, and both the desire of, and necessity for, banking organizations to broaden their scope of activities in order to operate successfully.

More generally, many of the arguments about competitive disadvantages of higher capital requirements are short-sighted. Well-capitalized banks are the ones best positioned to be successful in the establishment of long-term relationships, to be the most attractive counterparties for a large number of financial transactions and guarantees and to expand their business activities to meet new opportunities and changing circumstances. Indeed, many successful United States and foreign institutions would today meet substantially increased risk-based capital standards. In addition, the evidence of recent years suggests that U.S. banks can raise sizeable equity.

Higher capital standards should go a long way toward inducing market-like behavior by banks. However, the Board believes that so long as a significant safety net exists, additional inducements will be needed through an intensification of supervisory efforts to deter banks from maintaining return on equity by acquiring riskier assets. Where it is not already the practice, full in-bank supervisory reviews—focusing on asset portfolios and off-balance sheet commitments—should occur at least annually, and the results of such examinations should be used to evaluate the adequacy of the bank's capital. If the resultant capital is not consistent with minimum capital standards, the process of requiring the bank either to reduce those assets or to rebuild equity capital should begin.

If credible capital raising commitments are not forthcoming, and if those commitments are not promptly met, the authorities should explore such responses as lowered dividends, slower asset growth or perhaps even asset contraction, restrictions on the use of insured brokered deposits, if any, and the divestiture of affiliates with the resources used to recapitalize the bank. What is important is that the supervisory responses occur promptly and firmly and that they be anticipated by the bank. This progressive discipline or prompt corrective action of a bank with inadequate capital builds on our current bank supervisory procedures and is designed to simulate market pressures from risk-taking. Some flexibility is certainly required, but the Board has in mind a set of credible responses in principle and a presumption that these responses will be applied in the absence of compelling reasons not to do so.

Such an approach—higher capital and prompt corrective action—would reduce the incentives some banks currently have to overinvest in risky credits at loan rates that do not fully reflect the risks involved. This implies that the organizers of speculative and riskier ventures will have to restructure their borrowing plans, including possibly paying more for their credit, or seek financing from non-insured entities. It is just such financing by some insured institutions that has caused so many of the current difficulties, and it is one of the objectives of our proposals to cause depositories to reconsider the economics of such credits.

Higher capital requirements and prompt corrective action will not eliminate bank failures. An insurance fund will still be needed, but we believe that, with a fund of reasonable size, the risk to taxpayers should be reduced substantially. As I have noted, higher capital requirements and prompt corrective action imply greater caution in bank asset choices and a higher cushion to the FDIC to absorb bank losses. In addition, an enhanced supervisory approach will not permit deteriorating positions to accumulate. Moreover, the Board believes that forced mergers, divestitures, and, when necessary, conservatorships should occur while there is still positive, albeit low, capital in the bank to limit reorganization or liquidation costs. Existing stockholders should be given adequate time to correct deteriorating positions, including providing new capital, but Congress should specifically provide the bank regulators with the clear authority and, therefore, explicit support, to act well before technical insolvency to minimize the ultimate resolution costs.

These reforms should be equally applicable to banks of all sizes. No observer is comfortable with the inequities and adverse incentives of an explicit or implicit program that penalizes depositors, creditors, and owners of smaller banks more than those of larger ones. The Board believes no bank should assume that its scale insulates it from market discipline. Nevertheless, it is clear that there may be some banks at some particular times whose collapse and liquidation would be excessively disruptive to the financial system. But no bank is ever too large or too small to escape the application of the same prompt corrective action standards applied to other banks. Any bank can be required to rebuild its capital to adequate levels, and, if it does not, be required to contract its assets, divest affiliates, cut its dividends, change its management, sell or close offices, and the resultant smaller entity can be merged or sold to another institution with the resources to recapitalize it.

Banks cannot rebuild, strengthen, and maintain the appropriate level of capital unless they are able to adapt to the changing competitive and technological environment. The ability to adapt is crucially dependent on broadening the permissible range of activities for banking organizations. At the same time, we should be sensitive to the implications of the potential extension of the safety net, directly or indirectly, under those markets that banking organizations are authorized to enter.

The Federal Reserve Board has for some time held the view that strong insulating firewalls would both protect banks and taxpayers from the risk of new activities and limit the extension of the safety net subsidy that would place independent competitors at a disadvantage. However, recent events have raised serious questions about the ability of firewalls to insulate one unit of a holding company from funding problems of another. Partially as a result, the

Board is in the process of re-evaluating both the efficacy and desirability of substantial firewalls between a bank and some of its affiliates. If thick firewalls raise costs and may not be effective, we must question why we are imposing these kinds of firewalls at all. Moreover, higher capital standards and prompt corrective action go a long way to limit the transference of the bank's safety net subsidies to bank affiliates that firewalls are designed to constrain. And, as such, they should greatly limit the risk of distorted market signals and excessive risk-taking over an expanded range of markets, as well as the unfair competition, that might otherwise accompany wider bank activities.

Indeed, authorization to use their expertise over a wider range of markets might well be limited only to those banking organizations that meet a new, higher capital standard. Consequently, Congress might wish to authorize bank supervisors to grant certain of these activities to only those entities that exceed such a standard. Those institutions that consistently exceed the capital standard perhaps could receive more flexibility in supervisory treatment. Such organizations would, however, still be subject to the same thorough annual examinations.

As you know, the Board has long supported repeal of the provisions of the Glass-Steagall Act that separate commercial and investment banking. We still strongly advocate such repeal because we believe that technology and globalization have continued to blue the distinctions among credit markets, and have eroded the franchise value of the classic bank intermediation process. Outdated constraints will only endanger the profitability of banking organizations and their contribution to the American economy. Beyond investment banking, the Board believes that highly capitalized banking firms should be authorized to engage in a wider range of financial activities as a part of the modernization of our financial structure and the maintenance of strong, profitable financial institutions that can compete in world markets.

Firms primarily engaged in the financial activities authorized to banking organizations should likewise be permitted to operate an insured bank. Congress, of course, will have to give careful consideration to how to handle the activities some of these entities are already engaged in that would not be permitted to banking organizations. More generally, as we expand the range of activities available to banking organizations, competitive equity suggests the desirability of functional regulation. But independent of regulatory or organizational structure, all of us should understand that the market, stockholders, and management will think of a bank and any associated units, affiliates or subsidiaries, not as a confederation of businesses, but as an integrated organization.

As a result, it may be more realistic, as I suggested earlier, to apply more limited firewalls to the new activities. Moreover, recognition of the integrated nature of the operations of the insured unit with the rest of the organization raises the question of the implications of a piecemeal regulatory structure with no means of insuring that the activities of the organization as whole do not impose undue risk on either the financial system or the safety net. We believe that some agency should be responsible for oversight of the entire organization, especially if expanded activities and less rigorous firewalls are adopted.

As the Congress considers modernization of our banking structure, it should not only widen the permissible activities of well-capitalized banking organizations, but also eliminate outdated statutes that only increase costs. The McFadden Act forces State member and national banks to deliver interstate services only through separately capitalized bank holding company subsidiaries, where permitted by State law, rather than through branches. Such a system reduces the ability of many small banks to diversify geographically and raises costs for all banking organizations that operate in more than one State, a curious requirement as we search for ways to make banks more competitive and profitable. The McFadden Act ought to be amended to permit interstate branching by banks.

In summary, Mr. Chairman, events have made it clear that we ought not to permit banks, because of their access to the safety net, to take excessive risk with inadequate capital. In the process of reform, however, we should be certain we consider carefully the implications for macroeconomic stability. The Board believes that higher capital and prompt corrective action by supervisors to resolve problems will go a long way to eliminate excessive risk-taking by insured institutions and would not preclude additional deposit insurance reform now or later. Moreover, we believe that with such an approach the Congress should feel comfortable with authorizing banking organizations to expand the scope of their financial activities. Indeed, we believe that permitting wider activities is necessary to insure that such organizations can remain competitive both here and abroad. Increased activities are also required to sustain the profitability needed if banking firms are to attract capital. To limit the risks of the safety net transference, some new activities might be made available by banking regulators only to banks with impressive capital positions. We believe that whatever the regulatory form and structure under which new activities are permitted, one agency should have oversight responsibility for the banking organization as a whole. It is also our view that with these suggested reforms, reliance on stringent firewalls would not be necessary. And the McFadden Act should be amended in order to permit banks to deliver their services at the lowest possible costs and to more easily diversify in the geographic risks.

Thank you very much, Mr. Chairman.

[The complete prepared statement of Alan Greenspan follows:]

FOR RELEASE ON DELIVERY
10:00 a.m. EDT
July 12, 1990

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing & Urban Affairs

United States Senate

July 12, 1990

I am pleased to appear before this Committee to discuss reform of the deposit insurance system and expanded activities for banking organizations. Like each of you, my colleagues and I have spent considerable time discussing and debating the issues. We are reminded almost daily of the potential for public cost of the deposit insurance obligation, made so painfully apparent by the failures and difficulties of so many thrift institutions. Similarly, both the Congress and the Board repeatedly are reminded of the erosion of the competitiveness of our banking system both domestically and internationally. The time has come when these issues must be addressed.

The hearings you are conducting, Mr. Chairman, will establish a record preliminary to the publication early next year of the FIRREA-mandated Treasury study of the issues. The Board is participating in this study and has conveyed to the Treasury the views expressed in this statement. By holding hearings at this early date, I hope that the Congress will be able to focus on the needed legislation immediately after the release of the Treasury study. Basic reforms are required both of the safety net and of the range of activities permitted banking organizations.

The fundamental problems with deposit insurance that must be addressed are clearly understood and are, I believe, subject to little debate among those with drastically different prescriptions for reform. The safety net -- deposit insurance, as well as the discount window -- has so lowered the risks perceived by depositors as to make them relatively indifferent to the soundness of the depository recipients of their funds, except in unusual circumstances. With depositors exercising insufficient discipline through the cost of deposits, the incentive of some banks' owners to control risk-taking has been dulled. Profits associated with risk-taking accrue to owners, while losses in excess of bank capital that would otherwise fall on depositors are absorbed by the FDIC.

Weak depositor discipline and this moral hazard of deposit insurance have two important implications. First, the implicit deposit insurance subsidy has encouraged banks to enhance their profitability by increasing their reliance on deposits rather than capital to fund their assets. In effect, the deposit insurance funds have been increasingly substituted for private capital as the cushion between the asset portfolios of insured institutions and their liabilities to depositors. A hundred years ago, the average equity-capital-to-asset ratio of U.S. banks was almost 25 percent, approximately four times the current level. Much of the decline over the past century no doubt reflects the growing efficiency of our financial system. But it is difficult to believe that many of the banks operating over recent decades would have been able to expand their assets so much, with so little additional investment by their owners, were it not for the depositors' perception that, despite the relatively small capital buffer, their risks were minimal. Regulatory efforts over the last 10 to 15 years have stabilized and partially reversed the sharp decline in bank equity capital-asset ratios. This has occurred despite the sizable write-off of loans and the substantial build-up in loan-loss reserves in the last three years or so. But the capital ratios of many banks are still too low.

Second, government assurances of the liquidity and availability of deposits have enabled some banks with declining capital ratios to fund a riskier asset portfolio at a lower cost and on a much larger scale, with governmental regulations and supervision, rather than market processes, the major constraint on risk-taking. As a result, more resources have been allocated to finance risky projects than would have been dictated by economic efficiency.

In brief, the subsidy implicit in our current deposit insurance system has stimulated the growth of banks and thrifts. In the process the safety net has distorted market signals to depositors and bankers about the economics of the underlying transactions. This has led depositors to be less cautious in choosing among institutions and has induced some owners and their managers to take excessive risk. In turn, the expanded lending to risky ventures has required increased effort and resources by supervisors and regulators to monitor and modify behavior.

But in reviewing the list of deficiencies of the deposit insurance system, we should not lose sight of the contribution that both deposit insurance and the discount window have made to macroeconomic stability. The existence and use of the safety net have shielded the broader financial system and the real economy from instabilities in banking markets. More specifically, it has protected the economy from the risk of deposit runs, especially the risk of such runs spreading from bank to bank, disrupting credit and payment flows and the level of trade and commerce. Confidence in the stability of the banking and payments system has been the major reason why the United States has not suffered a financial panic or systemic bank run in the last half century.

There are thus important reasons to take care as we modify our deposit insurance system. Reform is required. So is caution. The ideal is an institutional framework that, to the extent possible, induces banks both to hold more capital and to be managed as if there were no safety net, while at the same time shielding unsophisticated depositors and minimizing disruptions to credit and payment flows.

If we were starting from scratch, the Board believes it would be difficult to make the case that deposit insurance coverage should be as high as its current $100,000 level. However, whatever the merits of the 1980 increase in the deposit insurance level from $40,000 to $100,000, it is clear that the higher level of depositor protection has been in place long enough to be fully capitalized in the market value of depository institutions. The associated scale and cost of funding have been incorporated into a wide variety of bank and thrift decisions, including portfolio choices, staffing, branch structure, and marketing strategy. Consequently, a return to lower deposit insurance coverage -- like any tightening of the safety net -- would reduce insured depository market values and involve significant transition costs. It is one thing initially to offer and then maintain a smaller degree of insurance coverage, and quite another to reimpose on the existing system a lower level of insurance, with its associated readjustment and unwinding costs. This is why the granting of subsidies by the Congress should be considered so carefully: they not only distort the allocation of resources, but also are extremely difficult to eliminate, imposing substantial transition costs on the direct and indirect beneficiaries. For such reasons, the Board has concluded that, should the Congress decide to lower deposit insurance limits, a meaningful transition period would be needed.

A decision by Congress to leave the $100,000 limit unchanged, however, should not preclude other reforms that would reduce current inequities in, and abuses of, the deposit insurance system. Serious study should be devoted to the cost and effectiveness of policing the $100,000 limit so that multiple accounts are not used to obtain more protection for individual depositors than Congress intends. The same study could consider the desirability of limiting pass-through deposit insurance -- under which up to $100,000 insurance protection is now explicitly extended to each of the multiple beneficiaries of some large otherwise uninsured deposits. Both have been used at times to thwart or abuse the purpose of deposit insurance protection.

No matter what the Congress decides on deposit insurance limits, we must be cautious of our treatment of uninsured depositors. Such depositors should be expected to assess the quality of their bank deposits just as they are expected to evaluate any other financial asset they purchase. Earlier I noted that our goal should be for banks to operate as much as possible as if there were no safety net. In fact, runs of uninsured deposits from banks under stress have become commonplace.

So far, the pressure transmitted from such episodes to other banks whose strength may be in doubt has been minimal. Nevertheless, the clear response pattern of uninsured depositors to protect themselves by withdrawing their deposits from a bank under pressure raises the very real risk that in a stressful environment the flight to quality could precipitate wider financial market and payments distortions. These systemic effects could easily feed back to the real economy, no matter how open the discount window and how expansive open market operations. Thus, while deposits in excess of insurance limits should not be protected by the safety net at any bank, reforms designed to rely mainly on increased market discipline by uninsured depositors raise serious stability concerns. Public policy, therefore, should rely on other means as the primary mechanism to induce prudent bank policies.

A promising approach that seeks to simulate market discipline with minimal stability implications is the application of risk-based deposit insurance premiums. The idea is to make the price of insurance a function of the bank's risk, reducing the subsidy to risk-taking and spreading the cost of insurance more fairly across depository institutions. In principle, this approach has many attractive characteristics, and could be designed to augment risk-based capital. For example, banks with high risk-based capital ratios might be charged lower insurance premiums. But the range of premiums necessary to induce genuine behavioral changes in portfolio management might well be many multiples of the existing premium, thereby raising practical concerns about its application. Risk-based premiums also would have to be designed with some degree of complexity if they are to be fair and if unintended incentives are to be avoided. In any event, the potential additional benefits on top of an internationally negotiated risk-based capital system, while positive, require further evaluation.

Another approach that has induced increasing interest is the insured narrow bank. Such an institution would invest only in high quality, short-maturity, liquid investments, recovering its costs for checking accounts and wire transfers from user fees. The narrow bank would thus require drastic institutional changes, especially for thousands of our smaller banks and for virtually all households using checking accounts. Movement from the present structure for delivery of many bank services would be difficult and costly, placing U.S. banks at a disadvantage internationally. In addition, this approach might shift and possibly focus systemic risk on larger banks. Banking organizations would have to locate their business and household credit operations in nonbank affiliates funded by uninsured deposits and borrowings raised in money and capital markets. Only larger organizations could fund in this way and these units, unless financed longer term than banks today, would be subject to the same risks of creditor runs that face uninsured banks, with all of the associated systemic implications. If this were the case, we might end up with the same set of challenges we face today, refocused on a different set of institutions. We at the Board believe that while the notion of a narrow bank to insulate the insurance fund is intriguing, in our judgment further study of these systemic and operational implications is required.

If, in fact, proposals that rely on uninsured depositor discipline, risk-based premiums, and structural changes in the delivery of bank services raise significant difficulties, reform should then look to other ways to curb banks' risk appetites, and to limit the likelihood that the deposit insurance fund, and possibly the taxpayer, will be called on to protect depositors. The Board believes that the most promising approach is to reform both bank capital and supervisory policies. Both would be designed to reduce the value of the insurance subsidy. Neither would rule out either concurrent or subsequent additions to deposit insurance reform, such as the changes discussed previously, other proposals, such as increased reliance on subordinated debt, or new approaches that may emerge in the years ahead. In fact, higher capital, by reducing the need for, and thereby the value of, deposit insurance would make subsequent reform easier. There would be less at stake for the participants in the system.

At the end of this year, the phase-in to the International Capital Standards under the Basle Accord will begin. This risk-based capital approach provides a framework for incorporating portfolio and off-balance sheet risk into capital calculations. Most U.S. banks have already made the adjustment required for the fully phased-in 1992 standard. However, the prospective increasingly competitive environment suggests that the minimum level of capital called for by the 1992 requirements may not be adequate, especially for institutions that want to take on additional activities. As a result of the safety net, too many banking organizations, in our judgment, have travelled too far down the road of operating with modest capital levels. It may well be necessary to retrace our steps and begin purposefully to move to capital requirements that would, over time, be more consistent with what the market would require if the safety net were more modest. The argument for more capital is strengthened by the necessity to provide banking organizations with a wider range of service options in an increasingly competitive world. Indeed, projections of the competitive pressures only intensify the view that if our financial institutions are to be among the strongest in the world, let alone avoid an extension of the taxpayers' obligation to even more institutions, we must increase capital requirements. Our international agreements under the Basle Accord permit us to do so.

There are three objectives of a higher capital requirement. First, higher capital would strengthen the incentives of bank owners and managers to evaluate more prudently the risks and benefits of portfolio choices because more of their money would be at risk. In effect, the moral hazard risk of deposit insurance would be reduced. Second, higher capital levels would create a larger buffer between the mistakes of bank owners and managers and the need to draw on the deposit insurance fund. For too many institutions, that buffer has been too low in recent years. The key to creating incentives to behave as the market would dictate, and at the same time creating these buffers or shock absorbers, is to require that those who would profit from an institution's success have the appropriate amount of their own capital at risk. Third, requiring higher capital imposes on bank managers an additional market test. They must convince investors that the expected returns justify the commitment of risk capital. Those banks unable to do so would not be able to expand.

We are in the process in the Federal Reserve System of developing more specific capital proposals, including appropriate transition arrangements designed to minimize disruptions. However, at the outset I would like to anticipate several criticisms. For many banks, raising significant new capital will be neither easy nor cheap. Maintaining return on equity will be more difficult, and those foreign banks that only adhere to the Basle minimums may be put in a somewhat better competitive position relative to some U.S. banks. Higher capital requirements also will tend to accelerate the move toward bank consolidation and slow bank asset growth. However, these concerns must be balanced against the increasing need for reform now, the difficulties with all the other options, and both the desire of, and necessity for, banking organizations to broaden their scope of activities in order to operate successfully.

More generally, many of the arguments about the competitive disadvantages of higher capital requirements are short-sighted. Well-capitalized banks are the ones best positioned to be successful in the establishment of long-term relationships, to be the most attractive counterparties for a large number of financial transactions and guarantees, and to expand their business activities to meet new opportunities and changing circumstances. Indeed, many successful U.S. and foreign institutions would today meet substantially increased risk-based capital standards. In addition, the evidence of recent years suggests that U.S. banks can raise sizable equity. The dollar volume of new stock issues by banking organizations has grown at a greater rate since the late 1970s than the total dollar volume of new issues by all domestic corporate firms.

Higher capital standards should go a long way toward inducing market-like behavior by banks. However, the Board believes that, so long as a significant safety net exists, additional inducements will be needed through an intensification of supervisory efforts to deter banks from maintaining return on equity by acquiring riskier assets. Where it is not already the practice, full in-bank supervisory reviews -- focusing on asset portfolios and off-balance sheet commitments -- should occur at least annually, and the results of such examinations should promptly be shared with the board of directors of the bank and used to evaluate the adequacy of the bank's capital. The examiner should be convinced after a rigorous and deliberate review that the loan-loss reserves are consistent with the quality of the portfolio. If they are not, the examiner should insist that additional reserves be created with an associated reduction in the earnings or equity capital of the bank. If the resultant capital is not consistent with minimum capital standards, the board of directors and the bank's regulators should begin the process of requiring the bank either to reduce those assets or to rebuild equity capital.

If credible capital raising commitments are not forthcoming, and if those commitments are not promptly met, the authorities should explore such responses as lowered dividends, slower asset growth or perhaps even asset contraction, restrictions on the use of insured brokered deposits, if any, and divestiture of affiliates with the resources used to recapitalize the bank. What is important is that the supervisory responses occur promptly and firmly and that they be anticipated by the bank. This progressive discipline or prompt corrective action of a bank with inadequate capital builds on our current bank supervisory procedures and is designed to simulate market pressures from risk-taking -- to link more closely excessive risk-taking with its costs -- without creating market disruptions. Some flexibility is certainly required, but the Board has in mind a set of credible responses in principle and a presumption that these responses will be applied in the absence of compelling reasons not to do so.

Such an approach -- higher capital and prompt corrective action -- would increase the cost and reduce the availability of credit from insured institutions to riskier borrowers. In effect, our proposal would reduce the incentive some banks currently have to overinvest in risky credits at loan rates that do not fully reflect the risks involved. This implies that the organizers of speculative and riskier ventures will have to restructure their borrowing plans, including possibly paying more for their credit, or seek financing from noninsured entities. Some borrowers may find their proposals no longer viable. However, it is just such financing by some insured institutions that has caused so many of the current difficulties, and it is one of the objectives of our proposals to cause depositories to reconsider the economics of such credits. As insured institutions reevaluate the risk-return tradeoff, they are likely to be more interested in credit extensions to less risky borrowers, increasing the economic efficiency of our resource allocation.

Despite their tendency to raise the average level of bank asset quality, higher capital requirements and prompt corrective action will not eliminate bank failures. An insurance fund will still be needed, but we believe that, with a fund of reasonable size, the risk to taxpayers should be reduced substantially. As I have noted, higher capital requirements and prompt corrective action imply greater caution in bank asset choices and a higher cushion to the FDIC to absorb bank losses. In addition, an enhanced supervisory approach will not permit deteriorating positions to accumulate. Moreover, the Board believes that forced mergers, divestitures, and, when necessary, conservatorships should occur while there is still positive (albeit low) capital in the bank to limit reorganization or liquidation costs. Existing stockholders should be given adequate time to correct deteriorating positions -- including providing new capital -- but Congress should specifically provide the bank regulators with the clear authority, and, therefore, explicit support, to act well before technical insolvency to minimize the ultimate resolution costs.

These reforms should be equally applicable to banks of all sizes. No observer is comfortable with the inequities and adverse incentives of an explicit or implicit program that penalizes depositors, creditors, and owners of smaller banks more than those of larger ones. The Board believes no bank should assume that its scale insulates it from market discipline. Nevertheless, it is clear that there may be some banks at some particular times whose collapse and liquidation would be excessively disruptive to the financial system. But no bank is ever too large or too small to escape the application of the same prompt corrective action standards applied to other banks. *Any* bank can be required to rebuild its capital to adequate levels and, if it does not, be required to contract its assets, divest affiliates, cut its dividends, change its management, sell or close offices, and the resultant smaller entity can be merged or sold to another institution with the resources to recapitalize it. If this is not possible, the entity can be placed in conservatorship and liquidated.

I noted earlier that one response of some banks to the more intense competitive environment has been to draw down their capital buffer. These and other institutions cannot rebuild, strengthen, and maintain the appropriate level of capital unless they are able to adapt to the changing competitive and technological environment. The ability to adapt is crucially dependent on broadening the permissible range of activities for banking organizations. At the same time, we should be sensitive to the implications of the potential extension of the safety net -- directly or indirectly -- under those markets that banking organizations are authorized to enter.

The Board has for some time held the view that strong insulating firewalls would both protect banks (and taxpayers) from the risk of new activities and limit the extension of the safety net subsidy that would place independent competitors at a disadvantage. However, recent events, including the rapid spread of market pressures to separately regulated and well capitalized units of Drexel when their holding company was unable to meet its maturing commercial paper obligations, have raised serious questions about the ability of firewalls to insulate one unit of a holding company from funding problems of another. Partially as a result, the Board is in the process of reevaluating both the efficacy and desirability of substantial firewalls between a bank and some of its affiliates. It is clear that high and thick firewalls reduce synergies and raise costs for financial institutions, a significant problem in increasingly competitive financial markets. If they raise costs and may not be effective, we must question why we are imposing these kinds of firewalls at all. Moreover, higher capital standards and prompt corrective action go a long way to limit the transference of the bank safety net subsidies to bank affiliates that firewalls are designed to constrain. And, as such, they should greatly limit the risk of distorted market signals and excessive risk-taking over an expanded range of markets, as well as the unfair competition, that might otherwise accompany wider bank activities.

Indeed, authorization to use their expertise over a wider range of markets might well be limited only to those banking organizations that meet a new higher capital standard. Consequently, Congress might wish to authorize bank supervisors to grant certain of these activities only to those entities that exceed such a standard. Those institutions that consistently exceed the capital standard perhaps could receive more flexibility in supervisory treatment. For example, a notice requirement could be substituted for formal applications for activities permitted by law and regulation, provided that such acquisitions leave a banking organization's capital in excess of the higher standards. Other reductions in regulatory burden for highly capitalized banking organizations might also be appropriate. Such organizations would, however, still be subject to the same thorough annual examinations.

As you know, the Board has long supported repeal of the provisions of the Glass-Steagall Act that separate commercial and investment banking. We still strongly advocate such repeal because we believe that technology and globalization have continued to blur the distinctions among credit markets, and have eroded the franchise value of the classic bank intermediation process. Outdated constraints will only endanger the profitability of banking organizations and their contribution to the American economy. Beyond investment banking, the Board believes that highly capitalized banking firms should be authorized to engage in a wider range of financial activities as a part of the modernization of our financial structure and the maintenance of strong, profitable financial institutions that can compete in world markets. A banking system that cannot adapt to the changing competitive and technological environment will no longer be able to attract and maintain the higher capital level that some of our institutions need to operate without excessive reliance on the safety net.

Firms primarily engaged in the financial activities authorized to banking organizations should likewise be permitted to operate an insured bank. Congress, of course, will have to give careful consideration to how to handle the activities some of these entities are already engaged in that would not be permitted to banking organizations. More generally, as we expand the range of activities available to banking organizations, competitive equity suggests the desirability of functional regulation. Under such an approach, each area of activity should be subject to the same regulatory constraints as equivalent or very similar functions at nonbank firms. But independent of regulatory or organizational structure, all of us should understand that the market, the stockholders, and management will think of the bank and any associated units -- affiliates or subsidiaries -- not as a confederation of businesses, but as an integrated organization. Recognition of this reality suggests that it is perhaps inefficient, at best, and under conditions of financial distress, ineffective, to try to make integrated businesses behave as if they were a collection of independent firms.

As a result, it may be more realistic, as I suggested earlier, to apply more limited firewalls to the new activities. I have in mind here restrictions such as sections 23A and B of the Federal Reserve Act, which already limit the financial transactions between a bank and its affiliates, requiring collateral, arms-length transactions, and -- except when Treasury securities are used as collateral -- quantitative limits based on the bank's capital. Moreover, recognition of the integrated nature of the operations of the insured unit with the rest of the organization raises the question of the implications of a piecemeal regulatory structure, with no means for ensuring that the activities of the organization as a whole do not impose undue risk on either the financial system or the safety net. We believe that some agency should be responsible for oversight of the entire organization, especially if expanded activities and less rigorous firewalls are adopted.

As the Congress considers modernization of our banking structure to meet the needs of the 21st century, it should not only widen the permissible activities of well-capitalized banking organizations, but also eliminate outdated statutes that only increase costs. The McFadden Act forces state member and national banks to deliver interstate services only through separately capitalized bank holding company subsidiaries (where permitted by state law) rather than through branches. Such a system reduces the ability of many smaller banks to diversify geographically and raises costs for all banking organizations that operate in more than one state, a curious requirement as we search for ways to make banks more competitive and profitable. The McFadden Act ought to be amended to permit interstate branching by banks.

In summary, events have made it clear that we ought not to permit banks, because of their access to the safety net, to take excessive risk with inadequate capital. Even if we were to ignore the potential taxpayer costs, we ought not to permit a system that is so inconsistent with efficient market behavior. In the process of reform, however, we should be certain we consider carefully the implications for macroeconomic stability. The Board believes that higher capital and prompt corrective action by supervisors to resolve problems will go a long way to eliminate excessive risk-taking by insured institutions, and would not preclude additional deposit insurance reform, now or later. Moreover, we believe that with such an approach the Congress should feel comfortable with authorizing banking organizations to expand the scope of their financial activities. Indeed, we believe that permitting wider activities is necessary to ensure that such organizations can remain competitive both here and abroad. Increased activities are also required to sustain the profitability needed if banking firms are to attract capital. To limit the risks of safety net transference, some new activities might be made available by banking regulators only to banks with impressive capital positions. We believe that whatever the regulatory form and structure under which new activities are permitted, one agency should have oversight responsibility for the banking organization as a whole. It is also our view that, with these suggested reforms, reliance on stringent firewalls would not be necessary. And the McFadden Act should be amended in order to permit banks to deliver their services at the lowest possible costs and to more easily diversify their geographic risks. The Board has shared its views with the Treasury as part of our continuing consultations on these matters, especially in the context of their FIRREA-mandated study.

Finally, in considering all proposals, we should remind ourselves that our objective is a strong and stable financial system that can deliver the best services at the lowest cost and compete around the world without taxpayer support. This requires the modernization of our financial system and the weaning of some institutions from the unintended benefits that accompany the safety net. Higher capital requirements may well mean a relatively leaner and more efficient banking system, and they will certainly mean one with reduced inclinations toward risk. However, the Board believes our proposed reforms -- including the authorization of wider activities by banking organizations -- will go a long way toward ensuring a safer and more efficient financial system and lay the groundwork for other modifications in the safety net in the years ahead.

The CHAIRMAN. Thank you, Chairman Greenspan. You have covered a lot of ground. I appreciate the time, the thought, and the years of experience reflected in your observations. Let me ask those members who have come in to make their opening statements. Let me start with Senator Dixon.

Senator DIXON. Well, thank you, Mr. Chairman. I'm anxious to ask the distinguished Chairman some questions, so I'm going to put my statement in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, this morning, as I understand it, the distinguished Chairman of the Federal Reserve Board, Alan Greenspan, will be testifying before this committee on two subjects: Deposit insurance reform and expanding bank powers. As everyone here knows, I have a real interest in both of these subjects. I am currently working on deposit insurance reform legislation, and I am the author of legislation that builds on the bank powers bill reported overwhelmingly by this committee in the last Congress.

I do not want to take much time this morning. I very much look forward to hearing the remarks of Chairman Greenspan. I only want to make one point.

I have read the written statement that has been submitted, and I note that the Federal Reserve Board places a lot of emphasis on strengthening bank capital. I strongly agree. That is one of the principal reasons I am pushing for a strong risk-based deposit insurance premium system. Risk-based premiums will push banks to improve their capital positions. Under a good risk-based system, banks will have a simple choice: Either maintain the amount of capital consistent with what the private markets would demand, or pay higher insurance premiums instead.

The Fed Chairman is absolutely dead-on when he says that deposit insurance and the safety net have worked to undermine the safety net we should be counting on—strong bank capital.

The risk-based deposit insurance legislation I am working on will ensure that banks have the capital they need, and it will also address a number of other issues raised by the Fed Chairman, including early closure, and making the current $100,000 insurance limit a real limit.

Sound deposit insurance reform is long overdue. I look forward to working with Chairman Greenspan, my colleagues on this committee, and all interested parties toward enactment of strong, effective reform legislation.

The CHAIRMAN. Very well. We'll make it a part of the record. Senator Heinz.

Senator HEINZ. Chairman, I'd ask unanimous consent to put my opening statement in the record.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I join you in welcoming Chairman Greenspan to our committee as we continue to explore how to fix our Federal Deposit Insurance System and to enhance the competitiveness of our financial services industry. I'm sure that Alan Greenspan feels that if he had a nickel for every time he has testified on this subject, he could help Congress significantly reduce the budget deficit.

Yesterday, I sponsored an amendment to the crime bill that was designed to protect the American taxpayer by enhancing our ability to recover funds from those who looted our savings and loans. I am pleased that the amendment was overwhelmingly approved by the Senate.

However, helping the American taxpayers to recover funds in the wake of a financial disaster places a poor second to the alternative of preventing a crisis in the first place. That is why reform of the Federal Deposit Insurance System and the restructuring of our financial services industry is so important.

The Fed's recipe for reform has some basic ingredients: (1) more private capital, (2) frequent and thorough examinations (3) tougher supervision for weak institutions, and (4) closing institutions before they bleed the deposit insurance fund and possibly the taxpayer dry.

Mr. Chairman, the Fed's recipe is certainly more simple than many of the reforms cooked up by previous witnesses. The solutions proposed by the Fed certainly look good, I hope Alan Greenspan will explain just how easy they are to swallow.

The CHAIRMAN. Very good. Senator Bryan.

Senator BRYAN. I'll defer any questions until I have time for my round, thank you, Mr. Chairman.

The CHAIRMAN. Very good. Senator Graham.

Senator GRAHAM. Defer until my round, thank you, Mr. Chairman.

The CHAIRMAN. I have statements from Senators Sasser and Sanford that will be inserted in the record at this point.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, today we will continue discussions on perhaps the most timely issue facing the Banking Committee today, the deposit insurance system. Our witness, Alan Greenspan, Chairman of the Federal Reserve Board, is in a key position to offer valuable insights into the current weaknesses of our federally backed insurance system.

Indeed, Mr. Greenspan, your interest in this topic is apparent in the remarks you made to the Federal Reserve Bank of Chicago, republished in the American Banker and in a recent edition of Business Week. Of most interest, you note that the "safety net" provided by deposit insurance tends to "increase the Nation's overall real rate of interest by facilitating the ability of riskier borrowers to translate their potential credit demands to effective control over resources, crowding out projects that would be economic at lower rates."

Now, Mr. Greenspan, we have certainly wandered down this path before in previous discussions, and my interest in lower interest rates is clear. The Federal Reserve Board, which you chair, has resisted cutting interest rates for quite some time, citing fears of inflation. I'll be interested to hear your evaluation of the factors causing high rates of inflation, and the inter-relation of deposit insurance and interest rates.

Moreover, the weakening real estate market and the havoc it is wreaking on regional economies, most colorfully demonstrated by the woes of tycoon Donald Trump, raise fears that we are heading for a recession. Relatively high interest rates are exacerbating an already weak economy. I'm interested in knowing whether you think elimination of deposit insurance would lower interest rates.

Mr. Chairman, I look forward to the discussion here today.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator **Sanford**. Thank you, Mr. Chairman. Let me first commend you for conducting these hearings on deposit insurance reform and the competitiveness of our financial industry in general. The Savings and Loan crisis on the one hand and increased international competition on the other, dictate that we study our current financial system closely. These hearings, which have brought a number of extremely qualified witnesses before us, have helped to clarify the issues involved and the potential solutions we must address.

Chairman Greenspan, let me also thank you for coming before us today to share your views on the revision of the deposit insurance system and the strengthening of the financial services industry in general. With the tremendous costs of the savings and loan debacle looming at every turn, all of us—taxpayers, members of Congress, the administration alike—have become acutely aware of the need for some type of change.

I believe it is important that our committee hear your response to the myriad proposals for reform, as well as your own ideas on where we ought to go. Especially important, it seems, are suggested changes in our present system of deposit insurance. Since Federal deposit insurance currently represents a major Government liability, alteration of this system must receive sincere consideration. I am particularly interested to hear your opinions on reducing the deposit insurance ceiling and limiting the total insurance coverage available to an individual.

As we focus on the testimony of expert witnesses like yourself, I hope the members of this committee will consider the various possibilities with urgency. It is absolutely necessary that we modernize the laws governing U.S. financial institutions in order to maintain an internationally competitive financial sector. But we must also take care to limit the risk such modernization might place on the Federal Government, and more importantly the taxpayer. It is therefore paramount that we fully understand the implications that each of these options would have for all American financial institutions, large and small alike.

I look forward to hearing your testimony this morning, Chairman Greenspan, as well as your answers to the questions that I am certain will follow.

Thank you, Mr. Chairman.

The **Chairman**. Chairman Greenspan, in your presentation here, you talk about a system where an individual citizen could have only one insured deposit of $100,000.

Chairman **Greenspan**. That is certainly one approach which we believe should be evaluated. It has a number of difficulties with it, but it does clearly require some evaluation because it would be, in my sense and the sense of my colleagues, a significant reform.

The CHAIRMAN. But perhaps a useful reform.

Chairman GREENSPAN. I think it would be a useful reform, but let's remember that it's technically difficult thing to implement.

The CHAIRMAN. Could we have people use a Social Security number, as they do for tax purposes, to identify their deposits?

But I want to get to a different question. Can the Fed estimate how many depositors, and banks would exceed the $100,000 limit? The data I have seen indicates that most people, the overwhelming majority of the people in the country with deposits in insured institutions, have less than $100,000.

Chairman GREENSPAN. That is correct. The Federal Reserve has made studies of the distribution of deposits by income class as a part of a sample survey. The latest available published survey is 1983. We have done one for 1989, and that will be completed relatively soon. The data are distributed by family groups, however, as distinct from individual depositors, and, as a consequence, we've been only able to collect the data on the total deposits held by family. What we've got is, for example, the percent of all families in this 1983 survey of consumer finances which report combined deposits in excess of $100,000. That is 1.4 percent of the total.

The CHAIRMAN. 1.4 percent of the American families in 1983?

Chairman GREENSPAN. As of 1983. The whole combined as a family.

The CHAIRMAN. Yes, understood.

Chairman GREENSPAN. Of those with more than $100,000 on an individual basis, the number would be less

The CHAIRMAN. It's even less than that? But we don't know how it may have changed. You're doing an updated number, but it looks as though 98 percent of the people in the country, even collected in families, would have insured deposits that total less than $100,000.

Chairman GREENSPAN. That's correct, Mr. Chairman.

The CHAIRMAN. So if we were to have a $100,000 limit per person, I would think that it would probably impact a very, very small number of people in the country.

On the other hand, it might impact a fairly large amount of money. In the 1 percent that have insured deposits above $100,000. So you know what the amount of outstanding insured deposits that might be?

Chairman GREENSPAN. We actually have that number.

The CHAIRMAN. What is that number?

Chairman GREENSPAN. The number I gave you, the 1.4 percent, was the percent of all families with deposits over $100,000. The percent of all deposits this represents is 28.6 percent.

The CHAIRMAN. That is significant. 1.4 percent of families with deposits above $100,000, hold 28 percent of all of the insured deposits in the country. That is a very large percentage.

Chairman GREENSPAN. Well that's all the deposits held by the group, including those which are uninsured. I mean, all we've been able to tabulate is that the 1.4 percent repesents 28.6 percent of total deposits. That would include some noninsured——

The CHAIRMAN. As a practical matter we have ended up paying off a lot of these deposits even though they were above the limit.

Now with respect to what the——

Chairman **Greenspan**. I want to make certain to say it's 28.6 percent of family deposits, not all deposits. It's only deposits held by families.

The **Chairman**. I think you've made that clear. If we were to suddenly—without a phase-in period—go to a $100,000 limit, could some substantial part of that 28 percent of the deposits move out of the banks and go somewhere else? Is that not a fair assumption? And how much might that be?

Chairman **Greenspan**. Well, Mr. Chairman, these numbers are not clean in the sense——

The **Chairman**. No, I understand. I'm trying to get a relative sense——

Chairman **Greenspan** [continuing]. And we're not quite sure exactly what type of number we're dealing with. If we think that there are problems in any type of legislative initiative, we would probably recommend some form of transition period, but it would depend very much on the purpose which the Congress was endeavouring to initiate and what our view of the ability of the market to absorb that would be. But it's obviously technically feasible.

The **Chairman**. Your updated information will help guide you into a recommendation. I want to ask one other thing before I yield to Senator Garn. Those persons who now have deposits above $100,000, whether by themselves or as a family unit, if they want a Federal guarantee, they would have the option, would they not, of buying Federal Government bonds or treasury bills.

Chairman **Greenspan**. That is correct, Mr. Chairman.

The **Chairman**. So it's not as if we would not leave people with a way of getting Government guaranteed security for their savings. They might have to put them in a different form to get that guarantee. Is that not right?

Chairman **Greenspan**. That is correct, Mr. Chairman. However, I think it is also important to focus on the problem that individual commercial banks would have if that shift is made, that is, from insuring deposits to insuring deposits of individuals, because clearly there is a substantial subsidy that is implicit in deposit insurance that not only goes to the individual holder of the deposit, but also to the depository institution.

I think it is important that in focusing on this particular initiative, one also be careful to understand and examine what the implications would be to a number of banks, most specifically, the community banks which do very much depend on the deposit insurance system.

The **Chairman**. Well you're exactly right. If my time were not up, we'd pursue that, but . . . Senator Garn?

Senator **Garn**. Thank you, Mr. Chairman. Mr. Chairman, looking back at FIRREA, do you believe that enacting the 70 percent QTL test was wise?

Chairman **Greenspan**. No.

Senator **Garn**. Could you elaborate why not.

Chairman **Greenspan**. Well, I think that the major problem that exists with the thrift institution goes back to the original concept of the institution as we envisaged it many decades ago and, most specifically, in the early post-World War II years when it moved forward and became a very major institution in this country.

It essentially was an institution which held long-term assets funded by short-term liabilities. That is a specialized institution which can only maintain itself in a non-inflationary environment where interest rates are low, stay low, and preferably—in fact, significantly preferably—long-term interest rates tend to be higher generally than short-term rates. Under those conditions, it is a profitable institution.

As we found out, that specialized institution ran into very serious difficulties in the late 1970's and the early 1980's as inflation took hold and interest rates rose, and the market value of those institutions dramatically declined to a point where there were very substantial mark-to-market reductions of the type that left the industry as a whole significantly insolvent. The test in FIRREA essentially is endeavouring to re-establish that sort of institution, I think, more on nostalgic grounds, because it really was an extraordinary, and I think a very important institution in helping to create homeownership in this country in that particular period.

But in resurrecting the nostalgia, I think we also have to concurrently resurrect the nostalgia for a low-inflation environment, because that's the only way in which the QTL test is going to allow thrifts to function. I would be concerned that recreating that type of institution that functioned so well in a specialized environment and so poorly in an environment more closely attuned to where we are today was not good policy.

Senator GARN. Well I agree with you, and I ask the question because I expected that answer. As I read the papers and listen to news every day and look at all of the supposed causes for the S&L crisis, and as people look for scapegoats, you have just outlined the primary cause of the S&L crisis, which nobody seems to want to talk about. Maybe it's too complex to understand interest rate mismatches, but I think it was a mistake to go back in the very direction that, as you have accurately described, was the major cause of the problem to begin with. The interest rate mismatch and the 21½ percent prime in 1979, and a specialized institution simply could not exist in that kind of a high interest rate environment.

I requested recently a Congressional Research Service report, Congress, on "U.S. Banks and Global Economy, Effects of Capital Tax and Regulatory Requirements." They just completed that study, and they note a rather dramatic decline in our competitive position. They also make a statement that is interesting after we've talked about Basle Accords, and, whether that's helpful or not, they say agreeing to internationally determined capital requirements for U.S. banks might not necessarily be beneficial to the United States in the long run because of the marked differences between the U.S. banking system and the systems of Europe and Japan.

Do you agree with that statement? The Basle Accords: we all say, "Isn't this nice. We reached this agreement." But here's somebody to say that may not be useful to us unless we modernize our system and become competitive.

Chairman GREENSPAN. Yes, sir.

Senator **Garn**. Well that was a clear, concise answer. It reminds me of the way Mike Mansfield when he was Majority Leader used to drive the press crazy. They'd say, "How do you feel about this? Are you——" And he'd say, "Yes." "Would you like to amplify your answer?" "No." They didn't know quite how to handle Mike.

I would also quote from the same report:

> Overall U.S. banks have not only been reducing their international presence, but have also lost significant ground to foreign banks in the domestic banking market. Furthermore, analysis of the regulatory banking environment in the United States and its major trading partners clearly shows that U.S. banks are at a competitive disadvantage vis-a-vis many of their competitors. Today the decline of U.S. bank assets abroad is mainly attributable to economic and financial developments within the United States.

I guess this gets back to my opening comment that at least there is finally, after a decade and a half, more of a recognition that our financial system does need modernization. So I would assume I would get exactly the same answer. You would agree with that statement as well.

Chairman **Greenspan**. Well I would say in general—I don't want to get into the specific questions of the degree of competitiveness of American banks, because it's a question which can——

Senator **Garn**. Well I understand. The major point of that statement that I'm asking you to answer is that, in the past, they're saying there were other reasons for lack of competitiveness overseas, primarily generated by the other countries. But what they're saying now is that it is our own lack of modernization and competitiveness within this country. I don't agree with every statement in here either in detail, but I'm speaking in terms of what we're talking about today, the need for modernization of our own financial system if we are to be competitive overseas.

Chairman **Greenspan**. I agree with that.

Senator **Garn**. My time is up. Senator Dixon?

Senator **Dixon**. Mr. Chairman, we're indebted to you for your contribution here this morning, and I think that what we've learned in the thrift crisis indicates there are a good many reforms that ought to be undertaken, and to the extent that you will lend your considerable prestige and high office to these efforts, I think it will help a good deal.

I'm pleased by your remarks on page 6. I quote from it, "A promising approach that seeks to stimulate market discipline with minimal stability implications is the application of risk-based deposit insurance premiums." And I'd like you to know, Mr. Chairman, that I'm presently working on legislation. We've been researching it for many, many months.

We'll shortly introduce a risk-based deposit insurance bill, and I would want you to know that before we do that, we'll show it to you and we'd be delighted to have your comments. And if you are able to support it, or if we can change it to satisfy your attitudes, I would appreciate your support.

Chairman **Greenspan**. Well we certainly will be delighted to look at it and give you our impressions.

Senator **Dixon**. I thank you. Now you talked about the limit of one account on $100,000 deposit insurance, and there's been some talk in the country about reducing the amount as well. Now my own personal inquiries of people like Bill Seidman and others leads me to believe that most people don't think that matters very much, but I'd be interested in your view. Do you think we ought to also reduce the insured amount or do you think the insured amount is all right if we limit it to one account per customer?

Chairman **Greenspan**. Well, Senator, as I said in my prepared text, if we were starting from scratch on the deposit insurance system, I would choose a number less than that. I don't think we need that much. But I would certainly agree with Bill Seidman that what is accomplished by moving it down from $100,000 is not very much. In other words, I wouldn't make too much of a big deal of that because I don't think it matters as far as the systemic problems we have——

Senator **Dixon**. So you wouldn't recommend that to the committee?

Chairman **Greenspan**. I would say that one should think about it, but it depends on what else one is doing. Certainly if the committee chooses to do that, the Federal Reserve Board would be fully supportive of it, but we're not pressing that as an issue because we agree with in the sense Chairman Seidman that it's not that major a policy question that confronts us.

Senator **Dixon**. As you know, we passed an expanded power bill here. We marked it up by a large number and this committee passed it overwhelmingly in the Senate. I presently have pending the so-called Proxmire Financial Modernization Act, which substantially altered Glass-Steagall. I think it's behind the curve now. I think we need to advance that bill some, and we'll reintroduce it next year, but I simply wanted to ask you, first of all, it's clear you do support expanded powers for our financial institutions to make us competitive in the international marketplace. Is that true?

Chairman **Greenspan**. Yes, I do.

Senator **Dixon**. Both as to debt and as to equity?

Chairman **Greenspan**. That is correct.

Senator **Dixon**. Now let me further follow along on this. Now there's a lot of criticism out there of expanded powers for thrifts as part of the problem that we saw in the thrift crisis. I would suggest, and I fully believe, that if you have adequate capital requirements and adequate regulation and supervision, there isn't any great risk in expanded powers, but I would want to hear that from you and have your view about it.

Chairman **Greenspan**. Well I certainly agree with that, Senator, and that clearly is the view of the Federal Reserve Board.

Senator **Dixon**. Well I'm indebted to you for that and would look forward to working with you on expanded powers this coming year.

Now that leads me to the final question: is it not a fact that with adequate deposit insurance system, as risk-based type insurance system, that adequate capital standards and prompt corrective action and good regulators and good supervisors, that you can protect the system? That, in other words, the expansion of powers—and I want to make that clear, because that's going to be a big issue around here in view of our experience with the thrift—the expansion of powers, reasonably done and correctly done with firewalls and so forth, is satisfactory and is something we ought to do to be competitive if we have these other criteria in place. Do you agree with that?

Chairman GREENSPAN. I do.

Senator DIXON. I am indebted to you, Sir. The Senator from Pennsylvania.

Senator HEINZ. No, I think——

Senator DIXON. I wasn't here for the early-bird round, Al. The Senator from New York.

Senator D'AMATO. I'm going, if I might, Mr. Chairman, to continue along the line of my good friend, Senator Dixon, has raised because I'm deeply troubled by the philosophy of expanded powers absent there being very strong firewalls or, put another way, a system that will guarantee that the very insurance system that we're talking about and raising questions about whether or not the $100,000 is too much as it relates to an individual, and then, of course, the question where they now have securitized these deposits, and so you have an individual who controls millions of dollars that are placed in various institutions at a $100,000 level.

Shouldn't we be extremely cautious in the area of expanded powers as it relates to the FDIC or the taxpayers' guarantee and absolutely have a system, notwithstanding adequacy of capital, that does not put at risk taxpayers' money for activities that go beyond merely the deposit function, which in essence was really why we've had the insurance? That was just really basically, put your money in our bank; it's invested locally; it has a small number of activities; rather safe, but we'll back it up in case there's mismanagement or fraud or something of that kind.

Chairman GREENSPAN. Senator, one of the things that has concerned me over the years is the subsidy that is implicit in the safety net, not only deposit insurance, but access to the Federal Reserve's discount window and payment system. The higher the subsidy, the greater the risk to the American taxpayer, and I think it's clearly an important goal of legislation to try to phase that subsidy down.

My own personal view and, in fact, as I've indicated in my prepared remarks, is that it's too high, that we've gone too far to displace the market forces—which really means bank capital—with the safety net. Indeed, Senator, if you go back historically, before we had the safety net, banks had to hold very significantly more capital. I'm not saying that the tremendous decline that has occurred in capital over the years is solely the result of the safety net, but a substantial part of it is, and I think it is fairly clear that the decline in the capital asset ratios in recent decades would have been very difficult were the safety net not there.

Firewalls could solve the problem of introducing expanded powers, which I think are necessary to maintain the viability of the banking organizations, if they work. One of the offshoots of our experience with Drexel is that it raised a very serious question about whether, in fact, those firewalls really work, whether the corporate veil or the specific walls that we would put up would hold in a crisis. And what we are examining is that question, and I must say to you there is increasing question whether they will.

If that is the case, then we conclude that the only way that we can support increasing powers is basically by bringing capital back up. It is, in fact, a substitute in part for firewalls. And that, Senator, is the reason why, when confronted with this dilemma—and we certainly share your view with respect to this question—why we have tended to move from firewalls back towards capital as a means to buffer the safety net.

Senator D'AMATO. Mr. Chairman, I appreciate your candor, and I think you've really laid out—this is not an easy subject—but the complexity of it. And while I certainly want our American financial institutions to be competitive in every manner, over the years I've been accused of being a protectionist for the securities industry.

Now, notwithstanding the fact that I am the Senator from New York, and the securities industry is rather important, not only to New York, but to the Nation, I have been. And it's been exactly on the basis that you have touched, that the banking institutions have a great subsidy. And when they compete, they will be competing unfairly unless there are adjustments and unfairly placing at risk taxpayers' money, having access to the Fed window, unless there are separate subsidiaries where there is not a drawing of capital that comes thinly protected and protected on one hand, inadequate capital, but protected by the Fed. Unless there are those safeguards, you're going to have unequal competition, but more importantly, I don't want to see taxpayers' money placed at risk.

And I haven't seen to date—and I'll be candid: I worked assiduously against the Proxmire Modernization Bill, because it did not address, to this Senator's satisfaction, these very questions that people are now looking at and mulling over. That's why some called me the obstructionist. I was. And I think we've got to be very, very careful so that we don't just rush in and say, "We want to be competitive," and leave status quo carryover, the same kinds of policies that have demonstrated their inadequacy in the thrift area.

And I don't see anything different in the area of the commercial activity as it relates to guaranteeing, again, that we don't have taxpayers' money undertaking some of these new and expanded activities that banks—and some of them are undertaking them already. As you know, the regulators are moving in. I've gone well beyond my time, but I have to say that we ought to take our time to see, and possibly disengaging from the system. Why should we be guaranteeing?

And I think maybe we do need an opportunity to disengage, some time to implement—but millions and millions of dollars on deposit that are placed in $100,000 denominations, that's not what the FDIC initially was for. It was to guarantee that a person's life savings would not be placed in jeopardy. But not millions and millions of dollars that are placed in different institutions by way of brokered deposits, et cetera.

So I think we've got to be careful as we work in this area. It's a difficult one. I don't have the answer, but I certainly don't think continuing on the path that we have been and expanding powers without there being some reform as it relates to what we guarantee, what the taxpayers guarantee. That is absolutely essential. And I want to thank the Chairman for his candor. Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato, I want to quickly comment for the record on something that we had discussed earlier.

Based on the Federal Reserve study, the most current study available, 28 percent of the deposits held by families are in amounts above $100,000. Yet they are held by only 1.4 percent of all of the households in the country. My guess would be, Senator D'Amato, that if you took a similar analysis over into the savings and loan industry during the last decade and include brokered deposits, that those figures would be even substantially higher. My guess would be that brokered money was overwhelmingly in amounts in the aggregate above $100,000, but belonging to a tiny, tiny percentage of individuals and depositors in the country.

I find that thought very troubling. I suspect that the data in the S&L industry would be even more extreme; 99 percent of the insured deposits in the savings and loan system were beneath the $100,000 limit they were not the money that was put at risk and lost. A very tiny percentage of individuals accounted for the vast amount of money put at risk and now lost.

Chairman GREENSPAN. I have no data on the thrifts, but one would assume that it would probably be the same order of magnitude. The mechanisms are quite similar.

The CHAIRMAN. Wouldn't brokered deposits drive it even higher?

Chairman GREENSPAN. Well, to the extent that there are broker deposits——

The CHAIRMAN. Those are a huge part of the story in the savings and loan situation——

Chairman GREENSPAN. Oh, I understand that, but I mean there are broker deposits in both commercial banks and in thrifts.

Voice. Could you yield for a clarification?

The CHAIRMAN. I will. I don't want to trespass too much——

Senator HEINZ. Just so we're working with the same database here, the statistics that Chairman Greenspan gave us related to percentages of deposits above and below $100,000 by families.

Chairman GREENSPAN. That's correct.

Senator HEINZ. What he has not told us is what percentage of total deposits do deposits by families represent of that universe of deposits, because that does not take into account any of the institutional deposits, the money market funds, the pension funds, all the other institutions that invest. And we may be giving ourselves a strange picture here by omitting those.

My guess would be that many individual investors of very modest means invested that are not counted in his statistics, as people with maybe $10,000 or $20,000 or $30,000; that is, were substantial investors through institutional intermediaries such as money market funds. But that is not a part of the analysis that's transpired so far, and I'm wondering if we might just get that on the record so the record is complete, whatever the record is.

Chairman GREENSPAN. I think that is correct.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman. As always, Mr. Greenspan, we appreciate the candor in which you respond to our questions, and as you frame the issue for the Congress to address, we want on one hand to make America's financial institutions more competitive globally, and I think most, if not all, of us share that objective. I certainly do. At the same time, we don't want to do anything to jeopardize the financial stability of those institutions and, in particular, in light of the experience, the disastrous experience, with our savings and loan situation, we don't want to put the American taxpayer at risk.

Now, as I understand both your prepared testimony and your answer to several questions, you've advocated for an expansion of bank powers to make our banking system more competitive. I must say that I share some of the concerns of my distinguished colleague from New York, because those that are advocating expanded powers within the industry are saying, "Look, we can establish fire walls to protect the various activities of the subsidiaries whether it's insurance or whatnot, and we can protect against any abuse."

And then as I read your testimony, if I understand it correctly, you're saying in effect at page 14, I believe it is, that you're not sure based upon the experience in the Drexel Burnham case that firewalls will indeed provide that adequate protection. May I say with the greatest respect, that's not the most powerful argument to make to a jury to expand powers. And I want to give you an opportunity to address that, because I wasn't part of the colloquy in which my distinguished colleagues who serve on this committee were back in 1988 when this issue was debated.

Chairman GREENSPAN. Well, Senator, I think the problem we have to focus on is whether firewalls work or don't irrespective of what we would like in the abstract. And clearly I have no question that when one is advocating expanded powers, it is argumentatively useful to be able to say that firewalls work. I'm confronted with the problem that the evidence is a little shaky.

And I must say to you, Senator, one of the reasons why I tend to come out in favor of higher capital is because, on the one hand, I think the expanded powers are necessary, and that, two, if firewalls are not working as well as we would like, then we have to have an alternate that does the same thing. Capital and prompt resolution does the same thing.

So I would much prefer to be supportive of things which I know will work, from which we have very significant experience, than to depend upon something we're not sure of.

Senator BRYAN. And, once again, I appreciate your candor, because without—well, to paraphrase what you're saying, you're saying in effect, the firewall argument is simply not persuasive.

Chairman GREENSPAN. Well let me——

Senator BRYAN. And you're saying that you believe on balance that because the compelling public policy leads you to conclude that we ought to expand bank powers that we relieve any anxiety that the American public or the Congress have by increasing capital standards, if I understand the thrust of your testimony.

Chairman GREENSPAN. That is correct, but let me just go a little bit further. We are obviously advocating restrictions as, in fact, currently exist in sections 23(a) and 23(b) which do create some degree of protection of the Federal Reserve Act, and we're not saying that all firewalls are unworkable. It's not an either/or proposition. Firewalls is a term we use for a number of different types of separation vehicles, so to speak.

What we have to do is to look at those which work better than others and not merely decide that we have the capability of establishing a considerable amount of such separations and assume that they will work effectively. That's the issue that we are evaluating. I cannot say to you we have fully concluded that none of them work. What we have concluded is that our previous judgment that they worked is subject to question.

Senator **Bryan**. I appreciate that. Would you agree, Mr. Greenspan, that the practice of broker deposits do increase the risk to the American taxpayer in terms of putting additional potential pressure upon the fund itself.

Chairman **Greenspan**. Yes, I do, Senator.

Senator **Bryan**. Would it be your opinion that that practice ought to be eliminated in any reforms that we consider with respect to addressing bank powers?

Chairman **Greenspan**. Well, remember that there are certain characteristics of brokered deposits which have advantages, namely, that they do improve the liquidity of the system. They do facilitate, to a considerable extent, the marshalling of depository funds.

Nonetheless, they do potentially create significant risks, and what I am saying is, rather than abolish them, I think one should focus on those aspects of brokered deposits which are positive and try to find the means legislatively to keep that aspect of the system in place without exposing ourselves to the abuses which have clearly existed in recent years.

Senator **Bryan**. As we struggle to develop or fashion the global model that will make our financial institutions competitive, it was helpful to me to hear testimony, as the other members of this committee did, from an individual representing, or at least a representative part, of the Japanese banking community.

The European banking community, West Germany in particular, and Britain, all three of them, if I understood their testimony, indicated brokered deposits do not exist in Europe and Japan. And each indicated to us, in one form or another, that whatever their insured basis of the deposits was done, in effect, through a private system, although in some countries a private system mandated by Federal law as opposed to a private system that evolved without the benefit of law. Is that something that we ought to consider in this country?

Chairman **Greenspan**. Well, I think that——

Senator **Bryan**. Or did I maybe misunderstand their testimony?

Chairman **Greenspan**. No, no, I think that is correct. I think that the deposit insurance systems in the European Community and in Japan are less extensive than ours, but they are moving in our direction. In other words, the European Community currently has under consideration the development of significantly broader deposit insurance, not to our levels or not to the extent that we have them, but they are basically moving in our direction.

I think that because our banking structure is really so different in many respects from either the European Community countries' system or Japan's, we should focus more specifically on the American experience and the American needs. I don't believe, with the different type of structure that they have abroad, that we can borrow readily any of their deposit insurance notions for application in this country and to our system.

Senator **BRYAN**. My time is expired.

The **CHAIRMAN**. Please continue. We've gone over a little in each question period. Take a minute if you wish.

Senator **BRYAN**. And I'm sure that your conclusion is correct, Mr. Chairman, that the systems are not absolutely—and the experiences of our financial institutions and our history are not identical and that there are, indeed, arguments that can be made for differences.

But assuming, as you argue, that broker deposits do place additional risk and strain upon the system, and as I thought I understood you to say, that there are also some advantages that are derived in this, what changes, if any, would you make in the broker deposit system? Because I think for those of us who have studied a little bit the history of insurance deposit, I don't think it was ever visualized that this would be an investment vehicle in which enormous capital investment could be, in effect, Balkanized and placed into segmented deposits.

It was designed, as I understand, to insure the relatively small or modest saver that his or her savings are safe and to encourage confidence in the financial system by middle income America.

Chairman **GREENSPAN**. Well, that's certainly correct, Senator. I think in previous deliberations on this, obviously the Congress has been evaluating brokered deposits and, as in FIRREA, when you chose to prevent them from being employed in troubled banks and thrifts, you were already moving in an appropriate direction.

I do think, however, that we ought to be careful not to just merely abolish them as a vehicle, because there are advantages which I think we probably could preserve without carrying the baggage of the excesses which we have perceived. That is one of the issues which we and the Treasury and other regulators will be looking at and hopefully will be able to present to this committee at an appropriate time. But at the moment I cannot say to you that I feel comfortable with any of the results to date.

Senator **BRYAN**. Thank you. And thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you, Mr. Bryan. Very important line of questioning. Senator Heinz.

Senator **HEINZ**. Chairman Greenspan, as always, your testimony is thought-provoking and very thoughtful. Just to follow up the issue of deposit insurance and deposit insurance reform, would it be your view that it would be a mistake for Congress, given what we've learned from the S&L debacle, to enact broad financial modernization without first attending to deposit insurance reform?

Chairman **GREENSPAN**. Senator, the more I think about the issue, the more it becomes, I think, clear that deposit insurance as an issue is part of the restructuring issue. I would hesitate to try to do deposit insurance independently of the other elements that I think this committee will address.

Senator **HEINZ**. Would it be fair to characterize your answer as "yes."

Chairman **GREENSPAN**. I think I'm saying—no. The answer would be "no" if I understood the question.

Senator **HEINZ**. Or "no," rather.

Chairman **Greenspan**. The answer is "no."

Senator **Heinz**. We shouldn't do financial modernization without first doing deposit insurance reform?

Chairman **Greenspan**. No, we should not do deposit insurance first, complete deposit insurance, and then go on to the rest.

Senator **Heinz**. No; we should not legislate piecemeal.

Chairman **Greenspan**. I think that's a mistake, yes.

Senator **Heinz**. But don't do financial modernization without doing deposit insurance reform.

Chairman **Greenspan**. Yes, sir.

Senator **Heinz**. Is it possible that, thinking back to the discussion of brokered deposits and the extent to which they have been a factor in the problems of S&L's, and perhaps to a certain extent a problem with banks, that one way to minimize the necessity of brokers performing the economic function now performed by brokered deposits is to permit, as you recommend, interstate branch banking?

That is to say, if a bank is operating in many areas or is free to go in to take deposits in an area where there is insufficient competition or insufficient choices for depositors, would that not in and of itself, to some, and possibly a very substantial degree, perform the same function that the deposit brokers now provide?

Chairman **Greenspan**. Most certainly.

Senator **Heinz**. So to the extent we make the adjustments in McFadden that you recommend, the function of the deposit broker is minimized?

Chairman **Greenspan**. It certainly is reduced, and I think it would certainly make it easier to eliminate the abuses.

Senator **Heinz**. I think that's a very important and critical point because, as you know, the changing of McFadden is very controversial, particularly with the small and independent bankers. And there needs to be a good public policy rationale, and this is a good one, it seems to me, for all of us to think about and bear in mind and examine.

On page 8 of your testimony, you express the Board's view, in effect, that it was a good idea to have higher capital and early intervention as principal strategies for reducing risks to the deposit insurance fund, and that should, of course, be a part of any measure that we might consider. In particular, on page 18, you say that higher capital and prompt corrective action by supervisors to resolve problems will go a long way to eliminate excessive risk-taking by insured institutions. Hard to find anybody, probably, who would disagree with that. It's real common sense.

It would appear that the Fed and other banking agencies have not implemented or instituted that policy in the past, and therefore the question is, if it's good advice now, why are we only getting really around to it as a premier principal of action today?

Chairman **Greenspan**. I think there are two reasons, Senator. First, with respect to the question of prompt action or prompt resolution, even though the regulatory authorities can take many of the actions which I outline in my prepared text, the mechanism by which they do it is very cumbersome and often quite prolonged, and so it is not an efficient means by which to address the question of prompt resolution.

Senator HEINZ. In order to implement this strategy, what do you need in the way of additional statutory authority?

Chairman GREENSPAN. At the appropriate time, when we have been able to get to the actual statutory language, we will list the specific types of actions.

I must emphasize, however, one problem that we are running up against, as you can well imagine, is that we have to be very careful that we are not going against the constitutional property protection against taking of, because if, for example, we as regulators shut somebody down who says he's got X percent capital, 1 or 2 percent, and in the process that capital is lost—as it may well be—then in a sense the Federal Government is inappropriately taking property from private citizens.

What is crucially important here is to make certain that the mechanism which is structured with respect to this type of legislation appropriately addresses that issue to be certain we are on constitutional grounds.

Senator HEINZ. Chairman Greenspan, I want to be clear on what you're saying. You started to say that the present process that you have to use can at times be very cumbersome.

How much of that is as a result of the constitutional due process limitation and how much of that is lack of statutory authority?

Chairman GREENSPAN. I don't know the answer to that question——

Senator HEINZ. Because that's a critical——

Chairman GREENSPAN. No, I agree with that——

Senator HEINZ [continuing]. It seems to me a critical question.

It seems to me that when the banks that the Fed regulated, the major money center banks, got into trouble with LDC loans back in the early 1980's the Fed as an institution—and I'm not pointing at you or at Chairman Volcker—but as an institution because the Fed does have a remarkable staff—did not come to us and say well we really ought to be much more aggressive and moving in on people. Why didn't we do it earlier?

Chairman GREENSPAN. Well I'm not sure that that is in fact the case because the capital of some of the major money center banks has been pressured to go up quite considerably in the last number of years since 1982——

Senator HEINZ. I wasn't so much thinking of the capital as I was of the ability to take early intervention action. And if it's true that the present authorities are too cumbersome—and you were here today saying well we're not sure whether it's due process or statutory authority——

Chairman GREENSPAN. No, I'm not saying——

Senator HEINZ [continuing]. Then why hasn't the Fed——

Chairman GREENSPAN [continuing]. I'm saying I don't know. I'm sure my general counsel behind me knows the answer to that question.

Senator HEINZ. Well then maybe you could answer that question for the record in writing.

Chairman GREENSPAN. Why don't I do that?

Senator HEINZ. OK. Thank you, Mr. Chairman, my time has expired.

[The response to Senator Heinz question follows:]

When credible capital raising commitments are not forthcoming, or if those commitments are not promptly met, the authorities should explore responses to recapitalize the bank. Applying progressive discipline or prompt corrective action to a bank with inadequate capital would build on the Board's current bank supervisory procedures and would simulate market pressures associated with risk taking—by linking more closely excessive risk-taking with its costs—without creating market disruptions.

While some flexibility is certainly required in this approach, the Board believes that there should be a prescribed set of responses and a presumption that these responses will be applied unless the regulator determines that the circumstances do not warrant them. Even though prompt corrective action implies some limit on the discretion of supervisors to forbear for reasons that they perceive to be in the public interest, it would be a mistake to eliminate completely the discretion of the regulator.

Accordingly, a system that combined a statutorily prescribed course of action with an allowance for regulatory flexibility would result in meaningful prompt resolution. For example, if a depository institution failed to meet minimum capital requirements established by its primary regulatory agency, the agency might be required by statute to take certain remedial action, unless it determined on the basis of particular circumstances that such action was not required. The presumption would thus be shifted toward supervisory action, and forbearance would require an affirmative act by the regulatory agency.

The prescribed remedial action required in a given case would be dependent upon the adequacy of the institution's capital. As the capital fell below established levels, the supervisor could be required to order the institution to formulate a capital plan, limit its growth, limit or eliminate dividends, divest of certain nonbank affiliates. In the event of seriously depleted capital, the supervisor could require a merger, sale, conservatorship or liquidation.

In adopting such a statutory framework, Congress could consider designing the system so that forced mergers, divestitures and, when necessary, conservatorships would be required while there is still positive equity capital in the depository institution. While existing stockholders should be given a reasonable period of time to correct deteriorating capital positions, Congress could specifically provide the bank regulators with the clear authority, and therefore explicit support, to act well before technical insolvency in order to minimize the ultimate resolution costs. The presence of positive equity capital, even if at low levels, when combined with any tier two capital, would limit reorganization and liquidation costs.

Most of the remedial actions discussed above can be taken, and have been taken, by bank regulators under the current legal framework. The regulators have acted pursuant to their cease-and-desist authority, after making a finding of unsafe or unsound conduct, or a violation of law, on the part of the institution. Under current law, however, the actions to be taken are discretionary, and implementation of a supervisory remedial action can be extended over a protracted period of time where the depository institution contests the regulator's determination.

In cases where an institution's capital is deteriorating, the progressive discipline framework described above would establish a systematic program of progressive action based on the capital of the institution, instead of requiring the regulator to determine on a case-by-case basis, as a precondition to remedial action, that an unsafe or unsound practice exsits. This program would introduce a greater level of consistency of treatment into the supervisory process, place investors and managers on notice regarding the expected supervisory response to falling capital levels, and reduce the likelihood of protracted administrative actions challenging the regulator's actions. Congressional action clarifying the source of strength policy would also place bank holding company investors and managers on notice regarding the holding company's responsibility to its insured depository subsidiaries.

When all of the progressive disciplinary steps outlined above have failed to correct the situation, a conservatorship is the only remaining remedy available to the bank regulatory agencies to intervene in the affairs of an institution while it still has positive capital. Under a conservatorship, the banking regulators control the institution in the eventual hope that it can be nursed back to good health. Unlike some of the supervisory actions discussed above, placing an institution into conservatorship allows for an after-the-fact hearing, thereby eliminating some procedural burdens on the regulators.

The legal standards in FIRREA authorizing the Office of the Comptroller of the Currency to place a national bank into conservatorship include insolvency (or near insolvency), as well as a determination that the bank is in an unsafe and unsound condition "including having substantially insufficient capital." Thus, while an institution may still have positive capital and be placed into a conservatorship, what constitutes "substantially insufficient capital" is left unclear. Absent clarifying language about the nature of "substantially insufficient capital," courts may require capital levels to be quite low before approving a challenged conservatorship, in line with the other standards for conservatorship. Accordingly, clarifying legislation specifying the specific level of capital that could trigger a conservatorship would be beneficial in this area in order to ensure maximum flexibility to the banking regulators.

It is also unclear whether in a conservatorship, the Federal Deposit Insurance Corporation would have the authority to act promptly to sell the institution to someone with the resources to restore its capital. Legislation to confirm that authority would probably be needed.

FIRREA also applies the same standards to FDIC conservatorships over State-chartered banks, but with the added burden that the State banking regulators must first put an institution into conservatorship (or close the institution) under the standards reflected in individual State law. Thus, for State institutions, a nationwide conservatorship statute would be needed.

The CHAIRMAN. Very good, Senator Heinz.

Senator Graham, you wanted to have a moment to make a comment on the Schiff nomination which we are, of course, voting on today. So let me invite you to make any comments you want to make on that before you take your normal period of questioning with Chairman Greenspan.

Senator GRAHAM. Thank you, Mr. Chairman.

We are voting today on the nomination of Joseph Schiff to be an Assistant Secretary in the Department of Housing and Urban Development.

I think this is an opportunity to look at the record over the last decade of these confirmation hearings. This committee has had 28 persons submitted to us for various positions requiring Senate confirmation within the Department of Housing and Urban Development between 1981 and 1988. Of those, only two failed to be confirmed, one of whom was withdrawn and not resubmitted at the end of a session of Congress.

In the hearings that we have held through the Select Committee on the Department of Housing and Urban Development we have found that one of the basic causes of the many problems in that Department has been the quality of personnel with important responsibilities to the public, responsibilities which were either misunderstood, responsibilities which were frankly not accepted or responsibilities which the competence of the individual was not able to discharge.

I am casting my vote for Mr. Schiff because I believe that he meets the standards that justify confirmation. I am filing a statement which anticipates that our subcommittee report will contain some recommendations for greater attention by this committee to nominees within the Department of Housing and Urban Development, including a recommendation for the establishment of an advisory process analogous to that which is used by the Judiciary Committee in the confirmation of judicial nominees and increasingly being used by the Foreign Relations Committee in the confirmation of ambassadors and other important positions in our Foreign Service.

So I would submit for the record this statement in anticipation of a more lengthy set of recommendations when our final subcommittee report is available.

The **Chairman**. Very good, Senator Graham. And we will make your full statement a part of the record.

Mr. Chairman, I was interested in the response that you made to the question from Senator Heinz about the ordering of deposit insurance reform and the expansion of bank powers.

I would agree with you that we should not expand bank powers unless in concert with deposit insurance. I do not agree that, if we decide to defer the expansion of bank powers, we should not attend to deposit insurance. That is an issue of sufficient importance and value, whatever we do regarding bank powers, that it ought to be a priority for this committee and the Congress.

Why do you think we should defer consideration of deposit insurance reform until we're prepared to deal with bank powers?

Chairman **Greenspan**. Well, Senator, I'm raising the issue because the various activities which are taking place with respect to changing deposit insurance have effects or could have effects on Bank powers. If you're going to consider both of them they will interrelate with one another, and it's usually best to make certain that they are coordinated.

But obviously if you choose not to move on either—I'm not saying that one can't move without the other, obviously, when you were considering the Proxmire bill, you considered additional powers essentially independently of deposit insurance, and if you were to look at deposit insurance now without Bank powers, that would be appropriate evaluation and legislation.

I'm only saying that there is a relationship between the two and that I am a little concerned that if you do them sequentially you may find that you have done one and then, when you're evaluating the other, you find that you might have done it somewhat differently had you done it in concert.

Senator **Graham**. Your testimony emphasizes the importance of increased capital as the basic assurance to the public of the proper management of these institutions and as the buffer zone before they reach the insurance fund. We've seen in the S&L's difficulty in raising additional capital. In the commercial banks, both money center and regional, there has been some softening of their attractiveness as indicated by their stock values.

What is it that you think would be necessary in order to make commercial banks sufficiently attractive that they can in fact raise additional capital or are we going to be doing what we have done in the thrift industry and that is downsize the institutions so that the core of capital that they currently have becomes a larger percentage of their total operation?

Chairman **Greenspan**. Over the years, Senator, banks have been able to raise capital; they have been able to raise it in the external market, and they have been able to raise it through internal undistributed earnings.

Periodically banks, like all other institutions, run into difficult periods for financing, and currently this is one of those periods in which in recent months the stock market price of bank holding companies has gone down relative to the market as a whole.

But I think that you have to look at the somewhat longer term. In my prepared testimony I very specifically used the term "over time." In other words, I'm not saying that we should impose an immediate capital requirement and enforce it in the manner in which it is done with the thrifts; I'm not sure that would be productive. I am merely saying that it must be in place in a sufficiently restricted timeframe to be able to get the effects that I think we need.

It is a very difficult question. Capital fortunately has come up quite considerably in many of the major banks in recent years, and it's that process which we think has got to be continued and accelerated.

Senator GRAHAM. Returning to the thrift issue, there were news reports this week that the Resolution Trust Corporation was going to adopt a new strategy which would be to intervene before the bank—before the thrifts went into insolvency. The rationale for that new policy was the fact that waiting until after insolvency had resulted in less than anticipated recovery of the value of the failed S&L.

Could you elaborate on that new policy and specifically comment on whether you believe that we should facilitate other financial institutions and particularly commercial banks' capacity to acquire faltering thrift institutions before they become failed thrift institutions?

Chairman GREENSPAN. Well I think that the new initiative is the result of the experience which the Resolution Trust Corporation has had in watching institutions which were still viable, and still had some franchise value, but which moved into conservatorship or some mechanism which pulled them out of the private sector and then watched the market value of those institutions fall very significantly.

In other words, you can have an institution with, say, zero book capital or even an institution with negative book capital which still has positive market value because it has a franchise value.

But if you move that institution into conservatorship, the evidence suggests that you will eliminate a very significant part of the franchise value because people are not going to want to deal with an institution which seems to be in serious trouble.

So if you can find the means by which you can take a troubled institution and resolve it without going through the process by which it is perceived that the Government has taken it over, you probably preserve economic value and, as a consequence, limit the amount of pressure on the deposit insurance funds and on the taxpayer.

Senator GRAHAM. Could you comment on the last question, would you see any role for expanding the ability of other financial institutions such as commercial banks to move in in that pre-failure period as a part of the strategy of——

Chairman GREENSPAN. Yes, I think that is basically part of the overall direction of such a strategy, to try to enhance the incentives to do so by creating an asset which is more attractive.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

Chairman Greenspan, following up on the questions of my colleague from Florida and my colleague from Pennsylvania, I, too, will be very interested to see the report from your general counsel on why institutions are not closed down earlier.

On page 13 of your testimony you mention the need for Congress to ". . . provide bank regulators with clear authority and . . . explicit support to act . . . before technical insolvency to minimize the ultimate resolution costs."

Do you have in mind a specific test? Should we say if it falls below X percent or do you have some formula which you would recommend that we put into law?

Chairman Greenspan. Yes, in fact, what the statute would actually do would be to specify the capability of regulators to do certain things at various different points in a resolution. So that there would be authority to resolve the institution fairly quickly——

Senator Bond. Such as below——

Chairman Greenspan [continuing]. I mean, such as below X, whatever that X would be.

Senator Bond. Yeah, you're not—we don't have the X yet.

Chairman Greenspan. I would not like to mention an X.

Senator Bond. OK. At the appropriate time, we'll want to know what X is.

But the discussion brings to mind a conversation that some of us had with you just a few days ago in which many of my distinguished colleagues—all of us, I think—expressed concern over the credit crunch. And a number of us pointed out loans where we thought good loans had been called yet my colleague, the junior Senator from Florida, noted that if a bank had a loan that was adequately secured and it was performing very well, there was certainly no reason from a regulators' standpoint or from the bank's standpoint to require additional capital or to call that loan.

I am reminded that perhaps the regulators have been in the situation that we in Congress find ourselves in when we are asked by our constituents to cut spending in general but increase spending in specific.

And without carrying the analogy too far, if I remember my psychology courses correctly, one of the Pavlovian experiments with laboratory animals determined that if an animal was given a reward systematically when it followed one path and then started getting negative electric shocks when it went down the same path, it could quickly develop schizophrenia in the laboratory animal.

Are we in danger of giving the regulators the same conflicting signals when we all want you to insure the safety and soundness of all of our institutions yet want to complain about those specific institutions in our State where the capital is found to have been inadequate or examiners are calling what we in our wisdom think are good loans?

Chairman Greenspan. Senator, I think that goes with the territory of being an examiner. You are inevitably subject to that problem, and I think most regulators and examiners know that goes with the territory and try to resolve it as best we can.

Senator Bond. But I would move on to the serious question then do you feel that the slowdowns or the contraction of credit that we have seen and have experienced in, I believe, all areas of the country is at least in your judgment a responsible approach to the changing value of collateral? Is there an unnecessary regulatory contraction of credit or would you say in general that such contractions as we are seeing are essential to maintain the safety and soundness of financial institutions particularly in light of declining asset values in some parts of the country?

Chairman **Greenspan**. Well Senator, I wouldn't say that it is the regulators as such where the issue lies. I think that what we are observing is something which I think we are acutely aware of: namely, that if you are running into problems as a commercial bank and the loans that you're beginning to look at are turning a little sour here and there, you tend to pull back.

Indeed I might say to you that one of the problems that we have with this issue of raising capital, which Senator Graham raised, is that if we, for example, require an increase in equity to assets that goes up much too fast, we will find that commercial banks start to pull back on their basic lending activity.

Now we have thought about that, and obviously what the solution to that problem is is not to say that we will not increase capital but, rather, to say what can we do to offset that economic effect. Because the effect of a commercial bank pulling back is essentially something not dissimilar to what happens when the Federal Reserve tightens.

And what we are able to do under those conditions, I would say, would be essentially to offset any structural tightening that might occur by actually easing monetary policy, because one would essentially offset the other.

In fact, you know, we are currently grappling, with a similar problem. As I indicated to this committee several weeks ago, we have been closely watching various interest rate spreads and other indicators to determine if the pulling back of commercial banks to less lax lending standards is moving over the line and, in effect, creating a tightening in credit markets independent of actions by the Federal Reserve. The cumulating evidence indicates that commercial bank loan rates and collateral requirements are firming in the context of an unchanged Federal funds rate. This suggests a market tightening of modest dimensions may be occurring. If so——

The **Chairman**. I'm sorry, can I just ask, did you say may be occurring?

Chairman **Greenspan** [continuing]. May be occurring. That could have undesirable effects on the economy that the Federal Reserve would have to consider offsetting with an ease in monetary policy in a general way. We are monitoring this issue on a day-by-day basis because it doesn't necessarily follow that if the Federal Reserve takes a fixed position that the markets will stay that way.

What we are looking at and trying to make certain is not happening is that, even though we are maintaining a steady position, that the market, because of the issues we're discussing, is not tightening on its own. And that's something which I think we have to watch on a day-by-day basis.

Senator **Bond**. If I may follow up with one question.

A friend of mine who publicly admits to being an economist I saw early this morning and he asked if it is possible that we may be in a situation such as we were in 1982 where perhaps the change in velocity of money changed the monetary policy, so it was not just the supply of money but the fact that it was not turning over as quickly, that there was restriction within that that caused the recession perhaps to be more extensive than it necessarily needed to be. Is this one of the things that you are looking at; is that a possible analogy?

Chairman GREENSPAN. Well, I think one of the things that we're obviously evaluating is the money supply. Because if you'll observe the data that we publish, we have found a very significant slowing down in the rate of growth of M2, which we consider to be the most important of the money supply variables—an issue which, when I come up before you, Mr. Chairman, for the Humphrey-Hawkins hearing, I will evaluate in some detail.

But before I do that, let me just say that we have endeavored to examine those money supply data as best we can, and a substantial part of the slowing is attributable to this extraordinary change in the resolution of thrifts. But not all of it.

In other words, there are parts of this issue, of the money supply slowdown, which we do not understand in these terms, and that, in a way is another measure which is related to this issue I mentioned earlier about some evidence that loan rates are moving up relative to the cost of money in the commercial banking industry, which is suggestive of the fact that the markets are tightening independently of our actions.

And that's the reason we are looking very closely at this because we don't consider that a tightening at this stage would be desirable and, as a consequence, may have to act to offset that particular tightening. And that's what we are monitoring on a day-by-day basis.

The CHAIRMAN. I——

Senator WIRTH. Mr. Chairman——

[Pause.]

The CHAIRMAN. They, the reporters that rushed to the telephone outside left a half-second too early because they haven't heard what I'm about to say and what you're about to say in response——

Senator BOND. Come back, guys.

The CHAIRMAN [continuing]. So those that have remained behind are about to get the big story. [Laughter.]

I'm going to yield to Senator Wirth, but before I do, I want to tell you that when Senator Wirth finishes, I want to continue on this subject. I'm hearing something different from you now than we heard 3 weeks ago when we had the credit crunch hearing here. It may not necessarily be an inconsistency. Times change. Senator Bond, you were here for that credit crunch hearing.

But in any event, Senator Wirth, it's your question period now.

Senator WIRTH. Thank you very much, Mr. Chairman.

Chairman Greenspan, I'm pleased to have you here.

Let me ask two other questions before coming back to this, if I might:

Last week the President's spokesman said that the raising of deposit insurance from $40,000 to $100,000 was a major reason for the S&L debacle; do you agree with that?

Chairman GREENSPAN. Well I think it certainly is a reason. It's a reason in the sense that it clearly created what we like to say is an increase in the moral hazard.

Senator WIRTH. An increasing——

Chairman **Greenspan** [continuing]. In the so-called moral hazard, meaning that it created an incentive for people in the institution to take actions which were adverse to desirable market trends.

Senator **Wirth**. And how does that relate, for example, to, in importance—we're all looking around and trying to make sure that the American people can understand what happened in this, and one of the—or the item that he referred to as the major reason was the $40 to $100,000 increase.

How do you compare that, say, in importance to the 1982 legislation, in importance to the regulatory failure that Mr. Corrigan came in and told us about 2 or 3 weeks ago; what weight do you put on that?

Chairman **Greenspan**. How do you weight them?

First, I would say with respect to a conversation I had with Senator Garn before you had come in, in which we were discussing the earlier nature of the problem of savings and loans as being an institution constructed with long-term assets and short-term liabilities, an institution which could only be viable——

Senator **Wirth**. I understand.

Chairman **Greenspan**. In a specialized non-inflationary type of environment. And if one were to say what was the major cause of the problem, I would say it's that.

Because what that did was lead to the huge market value insolvency of the institutions in 1980 and 1981 and it created this massive problem with regulation Q. All of the other regulatory unwindings that occurred were an endeavor to attack that particular problem.

So in a sense many of the changes in regulation that occurred in the 1980's were in response to the problems that emerged as a consequence of the mismatch. One certainly can't say that about the supervisory lapse; that is an independent factor and I think unquestionably a major element in this whole affair.

But I think it would be a mistake not to recognize that there is a long-term history in this problem which really fundamentally starts with constructing an institution with a mismatch with respect to the maturities of assets and liabilities.

Senator **Wirth**. I understand that.

Chairman **Greenspan**. And a lot of the actions that were taken were reactions to problems that occurred as a consequence of that.

Now how one puts the relative weights on that, I frankly don't know——

Senator **Wirth**. So you sort of have a step-stone: the regulation Q——

Chairman **Greenspan**. Yes, exactly.

Senator **Wirth** [continuing]. The lifting of regulation Q, your move to $100,000 occurred at the same time, I think, you moved to Garn-St Germain in 1982, then you moved to—in the 1980's moved to try to close that gap, lack of supervision in the process——

Chairman **Greenspan**. I'm not saying that all of those particular actions directly relate, I'm saying they were influenced by that. If one were to try to figure out where is the cause of the problem and to weight it, I think it's rather difficult.

But I would certainly say that part of the problem was clearly the moving from $40,000 to $100,000.

Senator WIRTH. Let me ask you a second specific question.

You've testified this morning one of the great safeguards is the raising of capital standards for banks, for commercial banks.

How much of an increase do you think is appropriate, how much of an increase would you recommend?

Chairman GREENSPAN. Well, that's an issue which we're looking at very closely. I would hesitate to give you a number at this stage because I think that it's very difficult to——

Senator WIRTH. I mean are we talking about 10 or 50 or 100 percent or——

Chairman GREENSPAN. Oh no, we're not talking double digits, if that's what you're thinking, no.

Senator WIRTH. I mean you're not talking doubling the current capital requirements.

Chairman GREENSPAN. No, that would not be necessary and it would be, I think, undesirable. But I do think we're talking about orders of magnitude which are not at the margin; they would be over a long period of time, I think, not insignificant, but they're not huge discontinuities or anything of an amount which is just utterly inconceivable of being raised.

And remember it is very difficult for banks to raise capital to increase their capital base. They have done exceptionally well in recent years. I think to put on unrealistic standards would create more damage than help and I think it's that——

Senator WIRTH. Some tighter standards are important but unrealistic would not be good, OK, that's fine.

Let me ask you a third question to follow up a little bit on what Senator Bond was suggesting:

I can imagine that you're under some very significant pressure from the White House and the Department of the Treasury to lower interest rates and it was reported in the paper yesterday or the day before that you'd had a session with a number of Republican Senators on this particular issue.

Now is it feasible at this point to lower interest rates?

Chairman GREENSPAN. That's a basic policy question which really relates to how we evaluate what's going on in the economy.

Senator, with respect to your first question, let me say that there's another issue involved here:

I took an oath of office to act in my job in a manner which is consistent with the purposes of the Federal Reserve System. And I think that, while we all see in the newspaper all sorts of pressures that are put on me and my colleagues, first, that is wholly appropriate, I might say. In other words, we should be hearing from you, from the White House, from everybody, with respect to what they think the problems are. Anybody who can add new insight, new evidence which would help us do our job, I think that is important that we get that.

But I want to emphasize that we have, in a sense, a very important calling because we think that what we do is crucially important to the economy. And if we were to do something other than what we thought was the right thing to do, I think, speaking for all of my colleagues, we would have a very tough time——

Senator WIRTH. I did not mean to suggest in any way in my question that you were bending to pressure; clearly there is a lot of pressure out there and I can understand that and that's a real thing and I have enormous respect for you and the members of the Board in terms of the way you have to deal with these mega-pressures—maybe greater than anybody except those in the Oval Office.

But let me—to get to the question again, I mean, how would you describe to us your thinking at this point about interest rates and what the economy can handle and should be handling?

Chairman GREENSPAN. You mean other than what I just said previously?

Senator WIRTH. Well we went off into a diatribe on—or not a diatribe, into a very thoughtful discussion on the role of the Federal Reserve as an independent entity and we all appreciate that; we'd like to have your independent judgment on where the economy may be going and——

Chairman GREENSPAN. Well I'm coming back before this committee within a very short period of time to spend a great deal of time on that subject with you, so I would much prefer to leave that unless you had, you know, something very specific that you——

Senator WIRTH. Would it be possible to lower interest rates without a budget summit, do you think, agreement?

Chairman GREENSPAN. I would just as soon not respond to that question because it requires a very extensive hypothetical answer.

Senator WIRTH. Well I can think of a variety of other specifics, but I guess we're not going to get anywhere. I appreciate the independence with which you operate, Mr. Chairman, and you do a good job of that. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Pressler.

Senator PRESSLER. Thank you very much. I apologize for being late.

Mr. Chairman, it seems to this Senator that many people who are informed of the Government's policy as too big to fail are in a quandary about that policy: how and when it is to be applied, for example.

Would you care to shed some light on that subject? It is, of course—has much to do with the deposit insurance system.

Chairman GREENSPAN. Senator, you're raising one of the really major dilemmas that we have on a policy question.

On the one hand, it is fairly obvious that there are certain institutions under certain very special circumstances which it would be desirable not to liquidate because the consequences to the economy as a whole could be unacceptable.

However, having said that, I think it is incumbent upon us that before one makes that judgment I think you start with the presumption that if a bank is failing, irrespective of its size, that it should be allowed to unravel and liquidate. It is only if there are other overriding considerations with respect to that specific institution, with its relationships with other institutions at that particular time, which suggest that that would not be a desirable thing to allow to happen.

I know of no simple way to put that type of policy in a statute. I would strongly recommend against any statute which prevented us from under certain circumstances being able to prevent the liquidation of an institution. But on the other hand, I also feel very uncomfortable myself about what is clearly an inequity involved; in other words, after you become a special size, liquidation doesn't occur. Nonetheless, in all instances common stock shareholders and others completely lose.

The only thing that we would consider holding in place is essentially the claims side of a large institution under certain circumstances. But I can't think of any circumstances in which the shareholders of that institution should be kept whole nor any of the other type of holders other than those types of instruments which are crucial to the financial system.

What we find is in these types of events the crisis is unique. There's usually nothing like it that history enables us to say this is what you would do under certain circumstances. Because it's complex and unique, we have to, at that particular time, make a decision as to what we would believe would be the appropriate response as regulators in order to preserve the system, which is our responsibility.

And because of that complexity, it is very difficult to come out with a simple answer on this too big to fail or too big to liquidate type of question.

Senator PRESSLER. Thank you.

The CHAIRMAN. Thank you, Senator Pressler.

Chairman Greenspan, I was following very carefully what you said in response to Senator Bond. It seemed that you were responding from something in front of you that you'd thought through and which represents a very careful articulation of the point you wanted to make. But I want to go back over it because I think it's important that we understand clearly what you seem to be saying. Let me tell you what I understood from it. Then you can tell me whether or not I have the correct sense of it. I will not ask the Reporter read it back.

I understood you to say that the credit tightening at financial institutions—and perhaps properly so because we need to make sure that banks are being operated properly and prudently—may, totally separate and apart from Fed policy, be having an impact on credit availability in the country.

That at some point, the Fed might have to take it into account in making its policy decisions, so that we do not miss the policy targets because of an extraneous event that you did not initiate.

Chairman GREENSPAN. That is correct, Mr. Chairman.

The CHAIRMAN. Now let us go to step two. If you were to decide that you see a sizable credit contraction that you might have to adjust interest rates in order to offset that effect?

Chairman GREENSPAN. That's correct. What would happen, Mr. Chairman, is that if one perceives that the pulling back of the commercial banking system is tending to create a tightening of credit conditions and if, in our judgment they should be held reasonably stable, then we would have to offset that basically by increasing reserves in the system, and that probably would bring a very modest change in the level of the Federal funds rate.

The **Chairman**. And if you did that, wouldn't that lower interest rates somewhat?

Chairman **Greenspan**. Well, it would clearly lower the Federal funds rate, and it would probably offset the rise that we are sensing may be happening in the average commercial bank loan rate—not the prime rate, but the average rate that is being employed. So that, in a sense, it would be an offsetting action.

It is not an action which is in response to, say, economic events which we perceive to be deteriorating, because that is not what we see happening. The outlook remains very sluggish as I've indicated here 3 weeks ago, there is still no evidence that we can reliably focus on which, in effect, is saying that the economy is tilting over. We do not see that.

But what we have to be careful of is to make certain that the policy that we want to see in the money markets and in the credit markets is in fact implemented. That does not mean that we, in that process, stand still.

We have done nothing for 6 months, which is a very long time. It's extraordinarily rare that you can hold a steady policy and keep things in equilibrium.

What's happened in the last 3 weeks is some changes in the indicators which we mentioned that we were looking at then. In fact, I made a very special point, if you may recall——

The **Chairman**. I recall.

Chairman **Greenspan** [continuing]. That one of the things that we had to be careful about is that we knew that the rate of increase in debt or credit growth was slowing down, and we considered that good, not bad. Through the middle 1980's, we had a rate of increase in all of the credit and debt aggregates which was clearly well in excess of what we might term reasonable. What we are finding is that in recent quarters we're now getting, very fortunately, a restoration of a more normal set of relationships.

But, as I indicated 3 weeks ago, what our concern was is that it did not go too far. I mean, we all recognize that New England is a special problem, but it's the national issue that we're interested in. At that point, we did not have sufficient evidence to suggest that we were looking basically at yield or interest rate spreads which suggested that the extent to which credit is pulling back is adding more to the degree of restriction than we think is appropriate. It's basically those data which are beginning to show some signs of tightness. It's that issue which we are looking at together with the money supply data, which is suggestive of that particular phenomenon.

It's not that we are saying that the economy is eroding——

The **Chairman**. I understand.

Chairman **Greenspan** [continuing]. And that we think that something may or may not be required. Its that what we're seeing is that we're getting more credit tightening in the market than we had planned, as far as our policy stance was concerned.

The **Chairman**. Well it is very important that we understand you clearly, because this is different from what you said 3 weeks ago. You collect data each day and each week and as that data has accumulated your concern has grown.

Chairman **Greenspan**. Certainly. Of course.

The **Chairman**. In the last 3 weeks, data has come to you that has given you a heightened sense of concern?

Chairman **Greenspan**. Well, I would say it has created more evidence than we saw before.

The **Chairman**. I understand.

Chairman **Greenspan**. I mean obviously we saw certain things but you always see a number of things. I would say it's only been very recently that in my judgment——

The **Chairman**. Right.

Chairman **Greenspan** [continuing]. We're getting enough information from special surveys and other types of information that is suggestive of a qualitative change.

I must say to you it is not a big change. We're talking about very modest changes. But they are there.

The **Chairman**. Well the change is significant enough for you to mention it. As an expert you see a shift in the data, that causes you to wonder where the economy is going.

If you reach a judgment from looking at the money supply, that you do have a problem building up with credit restriction or contraction that you may have to make a monetary policy adjustment?

Chairman **Greenspan**. That's correct, Mr. Chairman.

The **Chairman**. Senator Graham, let me pose one other question before we go to a second round. It is also related to our credit hearing 3 weeks ago:

In your testimony today recommended higher capital standards. Would not increased bank capital requirements aggravate the tendency of banks to ration lending and so restrict economic growth?

Chairman **Greenspan**. In fact I think this is an important issue. In the whole context of trying to think in terms of raising commercial bank capital and endeavoring to maintain an appropriate monetary policy, this is one of the areas in which you begin to see the relationship between regulatory policy at the Federal Reserve and monetary policy: In the sense that, as I indicated to Senator Graham, the problem that one runs into in trying to elevate capital levels for regulatory and structural purposes inevitably leads you to potential consequences on the monetary policy side.

If we, for example, were to, through legislation or other means, force commercial banks to raise their capital inordinately in a short period of time, I don't think they'd be able to raise it in the market. What would happen then essentially would be an endeavor to pull back on their asset growth and that would create a degree of credit tightening which is very similar to the type of actions that we in our monetary policy positions take. And so, while it is not identical, there are differences in what parts of the economy are affected, we cannot have a monetary policy which is independent of our regulatory policy or vice-versa; they are related. And I might say that is one of the reasons why we think that maintaining some significant regulatory presence in the Federal Reserve—having supervision and regulation as a major element within the Federal Reserve System—is a major assistance to our monetary policy and, indeed, to our, as I would put it, crisis management if one wants to put that as a separate sort of issue.

The **Chairman**. A very important point I think. Thank you.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. Mr. Greenspan, you commented earlier that you felt that the fundamental causative factor in the S&L crisis was that mismatch that became apparent in the last 1970's and early 1980's, and then from that came a series of attempted remedies. That would lead one to feel that you felt the physician had done an inadequate job of diagnosing what the pathology was and then prescribed inappropriate medication. Is that an accurate analogy?

Chairman GREENSPAN. You mean during the early 1980's? No, I remember during that period that there was a good deal, I think, of correct diagnosis, but when you're dealing with such a huge problem in such an immediate short-term, crisis atmosphere, I think it was very difficult to get a real consensus, a workable consensus, to know what to do. And even if you had a very full knowledge, it's not terribly clear to me what other things you would have done.

The elimination of regulation Q, for example, was clearly correct. If you had kept that in place, we would have had the whole thrift industry, not to mention a lot of other institutions, just disintermediating. All of the deposits would have just run out of the thrift institution, and we would have had a massive FSLIC problem at that point.

I think what the aim of a good deal of the legislation at that time was was that it would alleviate the short-term problems and enable the thrift industry to work its way out of the problems which confronted it. Most of the endeavors during that period were largely ways to buy time for the system to stabilize and balance. I think that the failure of supervision was most unfortunate, and that probably could have made a very major difference, but it's easy to go back and say we could have done it all significantly differently. I'm not certain that given the circumstances at the time, given the alternatives, that there were that many things that would have actually been done differently. So it's true, I'd say, had everybody known what would happen as we do today, obviously things would have been done differently. But nobody did.

Senator GRAHAM. With the benefit of almost a year since the FIRREA legislation was adopted, do you believe that that represented an accurate diagnosis of the pathology as it existed in 1989, or are you satisfied with the effect that the prescription is having on the patient?

Chairman GREENSPAN. Well, as I mentioned very early on to Senator Garn when he was here when he raised, in a sense, that issue with regard to having the thrift test at 70 percent, and he asked me whether I thought that was desirable, and obviously my answer was "no". I thought it was precisely that reinforcing of the definition of a thrift which, in my judgment, was the fundamental cause of the beginning of the problem and that there was a nostalgia element involved such as "wouldn't it be nice if we could get savings and loans which lent 30-year fixed-rate mortgages and funded them with short-term deposits the way they did in the 1960's". Then, it was a viable institution, a very major contributor to the growth in home ownership in this country and I think something quite important as a financial institution, but, unless we go back to the nostalgia of very low inflation and have that in place for a long time, I don't think we can resurrect that type of institution in a viable manner.

Senator GRAHAM. I have spent some of the last few days in Spain, some of that meeting with some of their bank regulators and ministers of finance. They had a financial crisis in the late 1970's and early 1980's. Their response was to merge what was their equivalent of the thrift institutions into commercial banks and create a German-style universal bank.

Do you think that we should have or should today be looking at a merger of the thrift institutions into the commercial banks as a means of solving this problem?

Chairman GREENSPAN. No, I don't think that's necessary, Senator. I think that clearly legislation and economic and financial forces have tended to move the two institutions much more closely together. Commercial banks and thrifts today look far more alike as institutions than, say, 30 years ago by a fairly large order of magnitude.

It's fairly apparent that there are a number of very good thrifts that are doing well. They're profitable and they serve their communities in a very effective way. There's no need for them to become commercial banks. I think there are market forces out there which are changing the structure of both commercial banks and thrifts, but I see no need to have legislation which, in a sense, puts them all together because there is a significant part of the savings and loan industry which is viable, profitable, and I think it serves the nation well.

Merely because other S&L's created such terrible difficulties is not a reflection on those who did well. I don't think that those who did well should be penalized for the actions of their fellow thrift operators.

Senator GRAHAM. Mr. Chairman, I have two questions remaining. One is, we seem to have a series of——

The CHAIRMAN. Senator Graham, I have an appointment that I must keep. So I'm going to ask Senator Wirth to take over. Following your questions, Senator Kerry will go next, and anybody else who arrives in that order. I want you to understand, Chairman Greenspan, why I must leave at this point.

I appreciate the directness and the candor of your answers today. We have worked together a long time, and I've always found you to be straightforward and independent.

Chairman GREENSPAN. Thank you very much, Mr. Chairman.

Senator GRAHAM. Thank you, Mr. Chairman. During the 1980's we seem to have had a series of circumstances in which one of the fundamental purposes of the intermediary function served by financial institutions broke down, that is, a prudent allocation of credit and capital, the large amounts of loans to lesser developed nations which now are being substantially written off, the whole savings and loan circumstance in which hundreds of billions of dollars were loaned to enterprises that cannot pay it back. The Donald Trump situation as a personality sort of encapsulates that.

Do you think that we've had a system failure in the intermediation function of financial institutions and should that be part of our consideration as we look at financial institution modernization?

Chairman **GREENSPAN**. First of all, I think that considering the extraordinary events of the last number of years, the fact that our intermediary system and our financial system as such is in as good shape as it is important. It is in good shape. It functions very well. It's got a lot of parts of it which are in difficulty——

Senator **GRAHAM**. Even including the thrift debacle, you would suggest that overall the intermediary system has worked?

Chairman **GREENSPAN**. Well, let me put it this way. I'm talking about the total financial system which includes more than the intermediaries, or, put it this way, more than the deposit intermediaries. Obviously we've had significant problems in the deposit intermediaries.

If I were to pinpoint where, if there were systemic problems, I would say it's in capital. As I've indicated in my prepared remarks and as I've expounded in other fora, it's very difficult not to be impressed with the extent to which capital in depository institutions has, over the last century come down very dramatically as a ratio to assets. In part, that was facilitated by the construction of the safety net—the discount window just before World War I, deposit insurance in the 1930's and some other marginal elements in that period, and then, of course, the payments system in recent years.

Too much of the support from the safety net system has been employed to the deprivation of capital. Were we in a position where capital was much larger and reliance on the safety net much smaller, we surely would have had a major problem with the savings and loans, but nowhere near the type of problem which has actually emerged.

We would have had problems in a number of commercial banks, but, again, not of the order of magnitude that we are looking at now. Indeed, those of our commercial banks with very large capital positions have very readily weathered the storm with the LDC loan problems.

So if one were to look at the question in a systemic sense, I think the problem is capital, and it's one of the reasons why we at the Board are recommending that that's where the adjustment process should be most closely focused.

Senator **WIRTH** [presiding]. Mr. Chairman, if I might, let me briefly followup on the earlier discussion on what happened in the S&L area. We were going back to the late 1970's and the lifting of regulation Q. Regulation Q at that point had been a regulation requiring that banks and other financial institutions could not pay more than a certain level of interest.

Chairman **GREENSPAN**. Prohibited them from——

Senator **WIRTH**. Prohibited them from doing so. So then with the lifting of regulation Q, suddenly the cost of money became much higher to an S&L or other financial institutions. Right? They were out in the open market. Emerging were money market funds and other instruments.

So they were paying sometime 8, 10, at that point, quite high interest rates. But, in fact, what they were receiving for their money in terms of long-term loans on homes was down at 5½ or 6 percent, and that's the gap you talked about that was a real problem.

Chairman **GREENSPAN**. Exactly, Senator.

Senator **Wirth**. So the question then became, what were these institutions going to do about that gap? And one of the things that was introduced, as I remember, were mortgage rates that were variable interest rates, and that was allowed, that became one of the instruments to allow the institutions to have mortgage rates that would track more appropriately interest rates.

Chairman **Greenspan**. Short-term interest rates.

Senator **Wirth**. Short-term interest rates to allow them to adapt to higher costs of money.

A decision was made in 1982 under Garn-St Germain to allow the savings and loan industry to go into a whole variety of new areas. And one of the reasons for that, as you pointed out earlier, was to allow them to move into other fields of endeavor so that they could make more money to allow them to cover the gap, is that right?

Chairman **Greenspan**. No, it wasn't really to make more money, it was to invest in assets with shorter maturities.

Remember, another element was an endeavor to get the thrifts to borrow long-term; in other words, to get them into longer term certificates. However, that never really created enough in the way of rebalancing the mismatch between the average maturity of assets and the average maturity of liabilities and, as a consequence of that, pressure then began to go to the asset side of the balance sheet to find means by which the average maturity could come down so that the differential movement in interest rates would not create the type of problem that you suggest.

Senator **Wirth**. The major continuing gap that was there——

Chairman **Greenspan**. Exactly.

Senator **Wirth**. OK.

Chairman **Greenspan**. These were very considerable actions which, I think, were the right things to do at that point because the other alternative was to collapse the institutions. It wasn't that those actions were without risk; on the contrary, they were risky, but the question was, at that time relative to what? And in that——

Senator **Wirth**. Let me go back to that point. This is now early 1980's.

Chairman **Greenspan**. Yes.

Senator **Wirth**. We have had this gap, the question is how to close that gap. And it would seem—at that time, as I remember, there were a number of institutions that were pretty sound and with variable interest rates they continued to be in good shape and are in good shape today. There are a number who were not.

And a choice was made—or was this the case in the early 1980's—but a choice was made not to go in the direction you were suggesting earlier of closing down a number of institutions, shrinking the number of S&L's—if the choice was made not to do that, that would have had probably a significant budget hit, wouldn't it?

Chairman **Greenspan**. Well my——

Senator **Wirth**. If a number of S&L's had been closed down, we would have been going through something similar to what's happening today?

Chairman **Greenspan**. Yes. I've forgotten what the number is, Senator, but at the peak when you were matching those 5 and 6 percent mortgages on the one hand and the deposits on the other, then if you were mark-to-market on a liquidation basis the savings and loan industry was in severe red ink, if I may put it that way.

Senator WIRTH. Yes.

Chairman GREENSPAN. And the numbers were so huge that the thought of liquidating was mind-boggling. Some mechanism had to be found which would resolve that.

Senator WIRTH. Was there discussion in the early 1980's of liquidating and the look at that was that that would have been such an enormous cost at that point that looking for an alternative was the way and out of that search for an alternative grew Garn-St Germain, is that——

Chairman GREENSPAN. I was not here at that time so, I could not tell you what the actual deliberations were, either in the White House, the Treasury Department or in the Congress, but I do recall that there was an awareness of the size of what the insolvency gap was and it wasn't as though you could eliminate that; at that point that's what the industry was worth. You could not sell those 5 or 6 percent mortgages in the market other than at very severe discounts.

Senator WIRTH. Right.

I remember part of that debate in the early 1980's. I was on the Commerce Committee and we had jurisdiction over the securities markets. And our great concern at that point was that if deregulation of the S&L industry was passed for the purpose of trying to close this gap and allow the S&L's to get into a variety of new financial instruments and other investments, that there was not in place an adequate supervisory capability to assure that these financial institutions, as special as they are, would be adequately regulated.

Chairman GREENSPAN. No, I think that was a judgment which I don't recall was sufficiently wide-spread.

Senator WIRTH. That was one that——

Chairman GREENSPAN. Because it's clear in retrospect that——

Senator WIRTH. Well Congressman Dingell was pretty fierce on that, if you remember, and I chaired the Securities subcommittee there and that was the position that was taken by the committee.

We took a similar position when the Chicago markets were opened, and the administration wanted to move dramatically into a whole new set of instruments in Chicago, we had very much of that same perspective that the supervisory capability was not there.

Chairman GREENSPAN. Well Senator, let me just say that one thing that did affect the discussion was the experience that this country had in the 1930's with insurance companies. You may recall that we had a similar problem in the sense of mark-to-market: they were bust. We worked our way through that, they all became solvent, and everything was fine. It was that analogy which significantly influenced, I think, the issue of policy with respect to the S&L's in the 1980's.

Senator WIRTH. This is a very interesting history—and I want to go to Senator Kerry—but I think sort of looking at this and for us to, as well as we can, to understand what did happen—you know, why was the lifting of regulation Q so important——

Chairman **Greenspan**. Well if regulation Q was not lifted, you would have had a massive run on the thrifts. In other words if you had kept it there you would have had huge disintermediation and a very large number of thrifts falling into the FSLIC.

And so it was really an issue of damage control——

Senator **Wirth**. But with regulation Q on, commercial banks also couldn't pay more than 5½ or 6 percent a year, right?

Chairman **Greenspan**. That's true but remember they did not have huge portfolios of long-term fixed rate mortgages.

Senator **Wirth**. No, I understand that.

Chairman **Greenspan**. And that was a big difference.

Senator **Wirth**. That was a major—of course.

But when regulation Q was on, if you could not pay more than a certain interest rate, 5½ or 6 percent, and you were lending out at 5 percent for home mortgages you were OK. That was the—you were making that 1 percent gap if you were a healthy thrift, isn't that right?

Chairman **Greenspan**. Well I think it maybe is more than one, but the principle is right.

Senator **Wirth**. OK. But for the purposes of illustration, you were making that percentage there.

Now when regulation Q was lifted, was that lifted for commercial banks and for S&L's, correct?

Chairman **Greenspan**. Yes, it was.

Senator **Wirth**. Then if regulation Q hadn't been lifted, why would there have been such a run? If we had just left regulation Q on through the late 1970's and early 1980's——

Chairman **Greenspan**. If you had left regulation Q on, what would you have found is that a tremendous flood from thrift deposits into, say, Treasury bills would have occurred. It wouldn't have been going——

Senator **Wirth**. Because Treasury bills were paying a much higher interest rate——

Chairman **Greenspan**. Exactly.

Senator **Wirth**. And you had an artificial amount of interest that financial institutions could pay. Treasury's were much higher and—were money market funds then around at that——

Chairman **Greenspan**. Yes. In fact, it was that period which created that vehicle for precisely that——

Senator **Wirth**. That's because people were looking for something else, interest rates were high, inflation was high and out of that grew money market funds, competing instruments and, out of that, grew the lifting of regulation Q.

Chairman **Greenspan**. Yes.

Senator **Wirth**. Is that correct?

Chairman **Greenspan**. That's my recollection.

Senator **Wirth**. All right. Thank you. I raise this not for the purposes of any questions of you today but I think it's helpful for us to make a record and use your great expertise in attempting to understand what maybe some of the underlying elements of this were, and I appreciate—there's nothing like having a good economist with us.

Senator Kerry.

Senator **Kerry**. Thank you very much, Mr. Chairman.

Thank you, Mr. Chairman, and I apologize for having not been able to be here throughout the process. As you know, this is a little crazy around here and we all get torn in many directions.

Chairman GREENSPAN. I've noticed.

Senator KERRY. Let me begin, if I may—and I will not take too long, but I'd like to explore a couple of areas. And if it's one that you've been through thoroughly then I'll just go back to the record and if you'd just tell me that it's been satisfactorily answered; I'm undoubtedly going to step on a couple of prior questions.

The whole deposit insurance issue seems to be not as significant an issue either in Europe or in Japan. Can you tell me why that is?

Chairman GREENSPAN. I think the major reason is the difference in the banking structure. They have many fewer banks and, as a consequence, significantly larger branching as a mechanism for maintaining commercial bank presence.

The best way of seeing what the consequence of that would be is to think hypothetically of the United States in which, instead of our community banking, independent banking system, there were not independent institutions but branches of larger institutions.

If deposits flowed from one branch to the other and the branch from which it flowed was in trouble, there would be no difficulty because the parent could move the funds back into the branch.

If you now consider all of these institutions independently and you have funds moving from one institution to the other, it's fairly clear that you can get bank runs, systemic problems, and bankruptcies which wouldn't exist if they were all a single banking unit or just a few banking units.

Because we have considered that the independence of our community banking serves our communities well, we have a different structure for which we need different institutions. And deposit insurance emerged as one of those institutions which enabled us to maintain around 10,000 plus individual banking organizations.

The Europeans and the Japanese experience, while somewhat related, really doesn't apply to us in that respect.

Senator KERRY. Now part of these hearings are under the title of the issue of the Modernization of our Financial Services Structure. Is that in your answer and in the comparison of those systems and current successes thereof, any either or lesson any message with respect to the considerations we are currently undergoing about national banking and permitting broader services to banking institutions than they currently undertake; also insomuch as the fact that I guess our top bank in the country now just fits into the top 25 of the world, I think, depending on how you measure the capital.

So is our competitiveness and the whole question of the delivery of American financial services in fact less than it ought to be because of the restraints which we have kept on the system with respect to size and——

Chairman GREENSPAN. You mean individual size of the——

Senator KERRY. Yeah. Well the restrictions on the interstate banking and so forth.

Chairman GREENSPAN. Well, I think that, as I indicated in my prepared testimony and at length with some of your colleagues earlier, clearly interstate banking would be a significant improvement and, more concretely in my prepared remarks, speaking for the Board, we are requesting essentially an amendment to the McFadden Act which would enable interstate branching because part of the problem in that we see the competitiveness of American banks in the world reflects our inability to compete in certain aspects within the United States.

Now having said that, I don't think that one should measure the degree of American banking competitiveness in terms of asset size. In fact, capital is clearly the more appropriate issue. And if one looks at capital, we're no where near in that sort of difficulty. We're up much closer to the higher ranks as indeed the British are. The Japanese are down.

What I think is important is to recognize that competitiveness is not size necessarily but one's banking skills. We have enough large banking institutions in the international arena which are quite skillful and, in a sense, out-compete others so that we are not the low man on the totem pole by any means.

We are not where we used to be in the era when American commercial banking was so pre-eminent. Earlier in the post-World War II period the issue never came up as to whether we were competitive or not. Our relative competitiveness has gone down but it is not something which is of such a magnitude that it is a crisis of structure, if I may put it that way.

Senator KERRY. Accepting all of that, you nevertheless made the comment that the size and fungibility of funds within their structure has permitted them to cushion the bankruptcies and the failures in ways that our more individualized system doesn't. Would we be better able to take advantage with respect to that part of the current problem we face were they larger?

Chairman GREENSPAN. No, Senator, I didn't mean to say that it is the size of the institution, as much as I meant, that it's the difference between whether you have a very large branch network and a few banks—a system which doesn't effectively need deposit insurance because it's very difficult.

In the extreme case, if you had a single bank in a country and everything else was branches, and there was no movement of funds in and out of the country, the only place you could move your deposit if you wanted to move it out of one branch is into another branch of the same institution. In that sense, you don't need deposit insurance, because the system by definition cannot fail. I take that back. If there is a technical problem, you could fail. But, as a practical matter, it cannot fail.

And if you have two or three or six or seven major units, that statement is less valid; but, nonetheless, significantly so. If you have 10 thousand or more, the probability of an individual failure is much higher and deposit insurance is what helps in that respect. It's not the size of the overall institution, it's how many fragmented pieces you have.

Senator KERRY. In your testimony, you cited a number of different potential reforms with respect to the current structure. Looking at the current issue of depositors spreading their deposits around so that they have them in several accounts and therefore extend their coverage, perhaps, beyond the concept that really meant $100,000 in one instance, and that instance is now magnified, do you have a profile or is there a profile you've seen of deposits in the American banking system so that we know to what degree institutions have undertaken that kind of spreading and to what degree individuals have and where we are with respect to small depositors?

Chairman GREENSPAN. In answer to a similar question that Chairman Riegle raised, I put in the record certain data on households and families and ownership by size class. We did not put in the data on other deposits by non-household deposits. They're all rough estimates, and if you would like, I would see if we could get you those data.

Senator KERRY. Is that a practice that's been undertaken, that people will actually consciously spread those around in a way that says "Well, we got a $100,000 here. We got a $100,000 there." And they know they're covered completely in each place as a result?

Chairman GREENSPAN. Oh, yes, most certainly.

Senator KERRY. Absolutely. And that's fairly significant, isn't it?

Chairman GREENSPAN. Oh, sure. In fact, the whole purpose of so-called brokered deposits is to do precisely that.

Senator KERRY. And would you not say that is outside of the scope of the original intent, I mean, in the wake of the 1929 failure?

Chairman GREENSPAN. I would certainly think so.

Senator KERRY. Now in your testimony you suggest——

Chairman GREENSPAN. I did say in previous questions that brokered deposits have both positive aspects and negative aspects, and that I was arguing in my earlier remarks not to legislate their demise, because I think you'll throw out the good with the bad. It's possible, probably, to preserve the good aspects, the liquidity-improving aspects of brokered deposits, without the excesses which have caused us so much grief.

Senator KERRY. So you're saying to us we should not limit a coverage to specific $100,000 or less per depositor?

Chairman GREENSPAN. That is a different question. In other words, I think that if you decide that the deposit guarantee ought to apply only to an individual up to $100,000, not to individual deposits, that clearly will change the economics of brokered deposits very dramatically.

Senator KERRY. Well, wasn't the original purpose in the wake of the 1929 crash to guarantee that no one depositor was going to be destitute and that we wanted—sure, we wanted the soundness of the banking system preserved, but at the same time, the real thing that we didn't want to have happen was to have, you know, Mom and Pop who'd taken their money out of the mattress and put it in the bank to find that it was washed out completely.

Chairman GREENSPAN. Senator, I think there were actually two issues involved. That one, obviously, and also concern about runs, bank runs. I do believe that a significant amount of the discussion at that time as justification for deposit insurance did focus on an endeavor to prevent bank runs and various forms of crisis liquidations. It was perceived, and obviously in retrospect, correctly, that deposit insurance would stem that process and have a systemic value.

So I think it really was both of those factors that were involved.

Senator **Kerry**. I don't want to prolong this too much, but let me turn to another subject for a minute if I can. And you probably did have questions on this, but Felix Rohatyn has floated a concept to try to lessen the impact, the long-term impact on the S&L bailout cost, with the one-time surcharge concept. Others are searching around for whether or not if the wake of the decision that we made last January which was based on about a $70 to $80 billion estimate, we're not now dealing with something which may require an entirely different approach.

And I wonder if you feel there are options that are legitimate that we should be thinking about to minimize the cost of the S&L bailout.

Chairman **Greenspan**. Well, Senator, I think it's important——

Senator **Kerry**. To lessen it from where it is.

Chairman **Greenspan**. I think it's important to differentiate between two wholly separate issues. One is the cost of the S&L bailout, and the other is the financing of money borrowed to meet that cost if it is not met either from increased taxes or decreased expenditures in other programs.

Those are two very separate issues in the same sense that if one were to buy a house, one that would cost you $100,000, you don't say that the house cost me $400,000 because of the $100,000 cost plus the interest on the money I borrowed. You can either pay cash or you can borrow, and I think what Felix Rohatyn is raising is not a means of lowering the cost of the savings and loan bailout—that is what it is, and it's going to be whatever it is—as we're now estimating it, between $90 to $130 billion.

If you borrow the money, it doesn't change the cost of what the bailout is. It just——

Senator **Kerry**. But it could change—I think when people refer to costs, at least, when we do, many of us are thinking of ancillary costs, of attendant costs, not just the cost of the $90 to $130 billion or the cost of financing that, but the cost to the economy physically and psychologically and otherwise of resources diverted. And the issue is really, are there ways to, perhaps, revalue some of those assets.

I remember talking with you about this when you were here a number of months ago when we were originally thinking about how to structure this. And I think I asked the question then, you know, I remain concerned about the impact of the 1986 tax bill.

And many of us warned them that we thought we were going to create problems in the real estate industry. I think we did to a certain degree. I voted against the retroactivity and against the change in the passive investment rules. I still wonder if certain changes, perhaps just deductibility for losses to active partners and so forth, might not increase some viability in those assets which would diminish.

So, I mean, I think there are a number of ways of saying, can we reduce the costs here. And that's what I'm wondering.

Chairman **Greenspan**. Translating, in part, what you're saying is there are ways in which we can increase the value of existing real estate, which is——

Senator **Kerry**. It's one alternative. I'm really asking you, are there others or are there other ways that you are thinking about or that you might say we should think about which could conceivably reduce the spin-off costs of this.

Chairman GREENSPAN. No, Senator, clearly there are. In other words, every one of them has got a plus and a minus. If you reverse the passive investment issue in the 1986 tax act, I suspect that you would find that real estate values probably would rise somewhat. The cost to the taxpayer of resolving the insolvent S&L's would decline. The problem would emerge someplace else as a consequence of that.

I'm not referring specifically to passive investment, but just to the process. It's very rare that an administrative or a legislative action is taken which isn't on the one hand and on the other. I have not personally sat down and thought through other ways essentially to increase the value of real estate because, as far as I can see, that's the only practical issue here of significantly reducing that cost.

Now obviously if we get a budget agreement, a credible one, and long-term interest rates fall, and as a consequence of that, mortgage interest rates fall, that clearly will be of some help to the value of existing real estate in the system, and in that sense, I think it would be helpful. Going much beyond that, it's difficult to find individual things which have a clear, positive effect on real estate values without concurrently having negative problems associated with them.

Senator KERRY. Would it be better for the economy to take the hit, deal with this with a surcharge or cash, either through revenues or through programs foregone as opposed to bonding it out over a long period of time.

Chairman GREENSPAN. Oh, certainly. In other words——

Senator KERRY. It would be better?

Chairman GREENSPAN. Oh, sure. I mean, if you reduced the interest charges, which clearly are a significant element in the Federal budget, it would be helpful.

Senator KERRY. Is it your hope that the budget agreement currently being negotiated might contemplate encompassing that kind of approach also?

Chairman GREENSPAN. Well, I think it's automatic. I don't think that one has to, in that respect, think in terms of the thrift bailout problem. I think it's the overall issue of how does one reduce the budget deficit generally and, to the extent that you succeed, clearly you're going to have a positive effect, one, interest rates and, two, on interest payments as part of the budget in the years ahead. And that will clearly be helpful.

Senator KERRY. And the best impact on interest rates, which is critical to the mortgages you cited and to other investments, would be biting the bullet and facing it more up front.

Chairman GREENSPAN. If by that you mean getting a budget agreement——

Senator KERRY. No, not just getting the budget agreement, but dealing with the S&L costs, perhaps more directly and in a shorter period of time.

Chairman GREENSPAN. Well, Senator, I don't want to differentiate between the overall budget process and this particular issue because——

Senator **Kerry**. That's fair. I agree.

Chairman **Greenspan** [continuing]. Because I think that they are so interrelated that what we're trying to do is to get, as far as the positive issue is concerned, interest payments by the Federal Government down. And that can be done one way or the other, and they're interchangeable in this respect. There are technical differences about funding the S&L bailout and funding to affect the Defense Department, but that's a wholly different story and not really related to the question that you're posing.

Senator **Kerry**. Conceivably, if there is any salutary impact of this affair, and it's hard for people to find them, but conceivably one of them might be that we have become more conscious of other liabilities that are hanging over our head and of the Federal Government's possible expenditure of significant funds down the road there.

Could you just take a moment—you may have done this earlier, but—you wanted——

Senator **Wirth**. John, I'm going to have to cut you off.

Senator **Kerry**. Oh, OK, sure.

Senator **Wirth**. This is supposed to go back and forth a bit here.

Senator **Kerry**. Oh, OK.

This was going to be my last question.

Senator **Wirth**. You said that about 10 minutes ago. [Laughter.]

Senator **Kerry**. Well I'm just——

Senator **Wirth**. Go ahead.

Senator **Kerry** [continuing]. Exercising senatorial prerogative here——

Senator **Wirth**. I've noticed that.

Senator **Kerry**. You go ahead.

Senator **Wirth**. Let me, if I might, ask a question that I think will be of interest to Senator Kerry as well, and that relates to who in the country benefits in this whole S&L area.

There was a study out of Cleveland State or some academic institution that there was going to be an enormous flow of funds out of some areas of the country into other areas of the country. Have you or has anybody at the Federal Reserve looked at that? Do you know anything about this suggestion that there were going to be—Massachusetts was going to pay twice as much as Colorado in terms of bailing out Texas; I think that's about a fair set of those numbers, fair summary of those numbers.

Chairman **Greenspan**. I'm aware of what I read in the newspapers on that. It's obviously an issue in the sense that there are interregional differences here and, to the extent that the solutions are national, it does have regional effects.

But having said that, I've exhausted my knowledge on the subject.

Senator **Wirth**. You can't say how much it is but clearly there are going to be benefits in Texas, California, Florida, and Oklahoma——

Chairman **Greenspan**. Well—the word "benefit" doesn't seem to be appropriate——

Senator **Wirth** [continuing]. Or they're going to receive a flow of capital at the expense of non-S&L States, you know, like Massachusetts or Minnesota or——

Chairman **Greenspan**. I think there will be interregional flows. As I said, the word "benefit" is wholly inappropriate in my judgment to this whole thing.

Senator **Wirth**. I understand. I agree with that.

Let me go back, again, if I might to a bit of this history in 1982. In 1982 Garn-St Germain passed and we've gone over why that passed, what the purpose of it was. That passed, I believe, by a voice vote in the Senate and passed by a very large margin, about 375 to 25, 375 to 50, something like that, in the House.

That legislation passed and that effectively--that focused only on federally chartered thrifts, isn't that right, federally chartered S&L's, it would not have focused on State-chartered S&L's.

What then happened, as I understand it, was as the bounds on Federal institutions were loosened, there began to be a flow of funds out of State-chartered institutions to Federal institutions.

There was then a scrambling among State-chartered institutions to regain the advantage that they had before and they then went to their State regulators and a number of State-chartered institutions then became even freer than the Federal institutions. And it is those State-chartered institutions that were in the greatest need of supervision.

Now is that an accurate history from your perspective?

Chairman **Greenspan**. I've forgotten—one element which I'm not sure of is the flow into national institutions following Garn-St Germain, from State-chartered institutions. I don't know whether that's the case, but certainly the rest of what you say is clearly history.

Senator **Wirth**. But certainly then the State-chartered institutions became even more deregulated that the federally chartered institutions, that is correct.

Chairman **Greenspan**. That is correct, yes.

Senator **Wirth**. And the State-chartered institutions——

Chairman **Greenspan**. But they always were.

Senator **Wirth**. They always were.

But as the Federal institutions were deregulated by Garn-St Germain then the State institutions became even more deregulated?

Chairman **Greenspan**. I think that is——

Senator **Wirth** [continuing]. In order to stay ahead.

Chairman **Greenspan**. Yes. The one thing I don't recall is whether it was competitive in a sense, but the facts——

Senator **Wirth**. It probably was——

Chairman **Greenspan**. Probably——

Senator **Wirth**. Now who supervised those State-chartered institutions, do you know? Whose responsibility was it to supervise the State-chartered——

Chairman **Greenspan**. States, State banking——

Senator **Wirth**. There was no—was there not a responsibility or is there not a responsibility from the Federal Home Loan Bank Board, the old Federal Home Loan Bank Board to supervise any State institutions?

Chairman **Greenspan**. I've forgotten exactly what . . .

[Witness conferring with staff.]

Chairman **Greenspan**. The primary supervisor was the State——

Senator WIRTH. But they were insured by the Federal Home Loan Bank Board. The State institutions, who became even more deregulated, were insured by the Federal Home Loan Bank Board——

Chairman GREENSPAN. By the Federal Savings and Loan Insurance Corporation——

Senator WIRTH [continuing]. Through FSLIC, right?

Chairman GREENSPAN. Which is a subsidiary; FSLIC was a subsidiary——

Senator WIRTH. And that there were, therefore, a significant number of supervisory responsibilities that the Federal Home Loan Bank Board had for the deregulated State institutions because of their insurance responsibilities under FSLIC.

Chairman GREENSPAN. That is correct.

Senator WIRTH. Now at that time, had one followed the concern about these institutions and regulating or deregulating them, that would suggest that there should have been a larger number of regulators watching what these rapidly deregulated State institutions were doing. And that's one of the major issues as to what went on in the mid-1980's, what Jerry Corrigan a couple of weeks ago called a regulatory failure or a regulatory crisis, occurred during this period in the 1980's, isn't that right?

Chairman GREENSPAN. That is correct, yes.

Senator WIRTH. Now at that time Ed Gray was the Chairman of the Federal Home Loan Bank Board. He was the first Chairman of the Federal Home Loan Bank Board after Garn-St Germain passed, wasn't he?

Chairman GREENSPAN. I'm——

Senator WIRTH. I think so. Mr. Pratt was there during the passage of Garn-St Germain, Pratt left and then Mr. Gray was there——

Chairman GREENSPAN. I've forgotten. Pratt was there before he was but on what date——

Senator WIRTH. And then Garn-St Germain passed, I think Pratt left and Gray was there. Anyway, Gray was there during a 4 or 5 year period in the 1980's. And that was the time when we had this crisis.

Now just again for the purposes of looking at this it seems to me there are two things that we established earlier have to happen in an era of deregulation: one, you have to be sure that the instruments and the investments being made by savings and loan institutions are sound, that they make sense, you know, that they're not off doing a whole variety of absolutely crazy things—although maybe they were doing that. And second, that you were supervising them.

We had a number of hearings in the 1980's about this and in one on the level of supervisory personnel Mr. Gray testified very eloquently before this committee on that subject. He testified to us in 1988 that he had in fact asked for extensive support: he'd gone to OMB and asked for a great deal of help in terms of additional supervisory personnel and that he was—that he had been turned down. He said that he went to Connie Horner at OMB.

And, when asked if there were other people, he said:

> Well in the administration there were some who weren't following this very closely. I think if they had followed it more closely they might have been more careful with what they said but some were saying we were off the reservation—this came more from the Treasury than any place else—off the reservation in terms of asking for more supervisory personnel.

During that period of time, the sense was this was a deregulated industry, there should not be added more regulatory personnel; I think the record pretty much shows that.

In terms of looking back at what happened again and trying to understand what happened in the 1970's and 1980's—and the first discussion that we had was looking back at the history what were the financial conditions, what were the happenings in the economy that forced the gap that existed, why did the S&L's have to search for more money, why did Garn-St Germain occur, then, once Garn-St Germain occurred we have a pattern of no regulation and at the same time Mr. Gray told us—later in that same testimony he told us that there should have been a greater attention paid to what was the quality of the assets that the deregulated industry was getting into.

Chairman Gray—the Banking Committee said:

> Chairman Gray, in your prepared testimony you discuss a number of initiatives you took in 1983 and 1984 to stop the growth of asset quality problems that you saw the thrifts getting into. Among other things, these initiatives included regulations first to control broker deposits, second to impose controls on direct investment by thrifts, and, three, to put the growth limits on thrifts without adequate capital.
>
> Can you give us the position of the administration on each of these regulatory initiatives and your understanding as to why the administration adopted the position it did on each? First, on broker deposit what was the administration's positions?
>
> Mr. Gray. Well I don't think the administration had a position but Treasury had a position and a very strong-one: there was a great deal of acrimony as a matter of fact on this issue. The Treasury frankly did everything it could—I spent one evening, for example, seven hours, talking to Deputy Secretary McNamara just before we proposed the regulation.

And he goes on to discuss the same kind of resistance from the Treasury to attempts by him to put greater regulations on this. So we have a problem again going—documenting this problem of what Mr. Corrigan said in terms of this regulatory failure in the 1980's. That jibes with your understanding as to what transpired as well, is that right?

Chairman GREENSPAN. Certainly in retrospect the amount of supervision and regulation that was applied was inadequate to the task.

Senator WIRTH. And finally you had been involved yourself with, in this same testimony, discussions with Keating. You had worked for Mr. Keating or his company in the early 1980's or the mid-1980's or been a consultant——

Chairman GREENSPAN. 1984.

Senator WIRTH. And at that point you had felt that the quality of the Keating deposits were sound and had written a memo to that effect, that the investments——

Chairman GREENSPAN. I wrote a memo to that effect in early 1985 on the basis of their 1984 balance sheet. And my recollection was that that balance sheet looked pretty impressive at that time.

Senator WIRTH. At that time.

Chairman GREENSPAN. It didn't stay that way, however.

Senator WIRTH. It didn't stay that way. I understand

But what had happened then was that there was a degeneration really: we deregulated in 1982, things looked like they were going pretty well in 1983–1984 to close the gap and then there was a real degeneration of those assets from about 1984 to 1988; is that a fair summary of what would have happened within the industry?

Chairman GREENSPAN. I don't recall where it started or when the real deterioration set in, but somewhere in the mid-1980's it started to deteriorate fairly rapidly because interest rates were coming down, and that would have cured a lot of the problems had the assets been sound assets.

Senator WIRTH. So a lot of the—then the problem was that a lot of the assets in that mid-1980's period were not sound, a lot of the assets——

Chairman GREENSPAN. Well, remember there is another element here which is not irrelevant to any of this discussion and that's the sharp decline in the price of oil, which was the major factor that created a problem. My recollection was that after the price of oil fell fairly significantly, there was an attempt to diversify out of oil properties into real estate in the southwest on the grounds that that was a different industry. It turned out to be——

Senator WIRTH. The same.

Chairman GREENSPAN. And the consequence of that was that the attempt at diversification created some very serious problems, and it was those assets that essentially led in the latter part of the 1980's to the very significant erosion that occurred.

Senator WIRTH. Well that's very helpful, Mr. Greenspan. I thank you very much. This was—I think, just for the purposes of understanding and trying to make a record on all of this, it's a useful thing for us to do. We all have, you know, no matter where we are, a lot of questions that come at us all the time what happened. And this is an enormously complicated story over the last 10 or 12 years. And to try to be able to explain that in maybe a little more simple way—it's not easy but we're all going to have to try to figure out how to do that.

Chairman GREENSPAN. It's an extraordinarily complex story, Senator, which I think goes back into the 1950's and earlier actually.

Senator WIRTH. Fine.

Mr. Chairman, thank you very much for being with us and the committee will be adjourned. Thank you.

[Whereupon, at 1:27 p.m., the committee was adjourned.]

[Additional material supplied for the record and response to written questions follow:]

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CRS Report for Congress

U.S. Banks In The Global Economy: Effects of Capital, Tax, And Regulatory Requirements

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U.S. BANKS IN THE GLOBAL ECONOMY: EFFECTS OF CAPITAL, TAX, AND REGULATORY REQUIREMENTS

SUMMARY

Overall, U.S. banks have not only been reducing their international presence, but have also lost significant ground to foreign banks in the domestic banking market. Furthermore, analysis of the regulatory banking environment in the United States and its major trading partners clearly shows that U.S. banks are at a competitive disadvantage vis-a-vis many of their competitors. In many ways, the banks of U.S. trading-partners are better equipped to compete in the new regulatory environment than U.S. banks because of foreign competitors' relatively higher levels of deposits and savings rates. Foreign resistance to U.S. banks' expansion in foreign markets was a major factor in their poor performance in some foreign markets in the 1970s. Today, however, the decline of U.S. bank assets abroad is mainly attributable to economic and financial developments within the United States — the decline in U.S. savings, the main source of U.S. bank deposits; the relative decline in U.S. exports, the core source of U.S. international lending; and the financial turbulence caused by the S&L and foreign debt crises which have resulted in enormous institutional losses. All these developments spawned a general call in and outside the Congress for increased prudential requirements at home and abroad. The resulting increase in capital and loan loss reserves to make a sounder banking system has also contributed in the short run to the poor performance of U.S. banks in international and domestic competition with foreign banks. This is because regaining soundness is costly in that it absorbs financial and other resources that would ordinarily be used for income producing banking activities. These developments have made it difficult for U.S. banking institutions to raise capital in financial markets to meet the new internationally-determined capital requirements.

The examination of taxation on the U.S. banking competitiveness yields mixed findings. The banking industry is now subject to a higher effective tax rate than before the 1986 Tax Reform Act. While this tax increase on banking institutions has brought their effective tax rate in line with other U.S. industries, it may also have constrained U.S. banks' international competitiveness by reducing their aftertax profitability. However, despite the tax increase, U.S. banks, by some measures, have been relatively profitable in international banking. A more technical assessment of the effects of domestic and foreign taxation on the competitiveness of the U.S. banking industry concludes that domestic tax treatment of banks is of primary importance. As these tax rules stand, some U.S. foreign deposits and loans are penalized, while others are subsidized and it isn't clear which outweighs the other. Overall, the analysis suggests that the United States would not necessarily be better off if it increased the tax subsidy to banks in order to increase U.S. banks' competitiveness in the global economy.

This report was originally prepared at the request of the Honorable Jake Garn of the Senate Committee on Banking, Housing and Urban Affairs and is released for general Congressional use with the Senator's consent.

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U.S. BANKS IN THE GLOBAL ECONOMY: EFFECTS OF CAPITAL, TAX, AND REGULATORY REQUIREMENTS

As was pointed out in the 1985 CRS report, *U.S. Banks' Competitiveness in Foreign Domestic Markets*, foreign resistance to U.S. banks' expansion in foreign markets was a major factor in their poor performance in some foreign markets in the 1970s.[1] Today, however, the decline of U.S. bank assets abroad is mainly attributable to economic and financial developments within the United States – the decline in U.S. savings, the main source of U.S. bank deposits; the relative decline in U.S. exports, the core source of U.S. international lending; and the financial turbulence caused by the S&L and foreign debt crises which have resulted in enormous institutional losses. All these developments spawned a general call in and outside the Congress for increased prudential requirements at home and abroad. However, the resulting increase in capital and loan loss reserves to make a sounder banking system has also contributed in the short run to the poor performance of U.S. banks in international and domestic competition with foreign banks. This is because regaining soundness is costly in that it absorbs financial and other resources that would ordinarily be used for income producing banking activities.

THE DECLINE OF U.S. BANKS' INTERNATIONAL PRESENCE

THE EXTENT OF THE DECLINE

The number and size of U.S. banks' branches operating abroad are indicators of their ability to compete profitably in the global economy. An increasing number of branches and growing assets would be indicative of profitable foreign operations. However, according to the Federal Reserve's Board of Governors, in 1981 the total gross assets of U.S. branches peaked at $390 billion, while the total number of branches peaked at 916 in 1985. Since then, both assets and branches have declined. By 1988 total gross assets of these banks had fallen to $318 billion and the number of branches declined to 849. Domestically, U.S. banks' holding of bank assets in the United States dropped from 86 percent in 1981 to 79 percent in 1988. Conversely, foreign banks increased their holdings of U.S. domestic bank assets from $266 to $638 billion in those respective years. Over the same period, U.S. banks owned 97 percent of the domestic bank offices in 1981, declining to 95 percent in 1989.[2] This suggests that the average foreign bank office in the U.S. domestic market is significantly stronger financially than the average U.S. bank because foreign-controlled institutions generally hold far more assets per office than U.S. owned banks.[3]

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[1] U.S. Library of Congress. Congressional Research Service. *U.S. Banks' Competitiveness in Foreign Domestic Markets*. Report No 85-135 E, by Walter Eubanks. Washington, 1985. 28 p.

The wealth of the foreign bank offices is partly attributable to U.S. import of capital and goods and services. Many exporters to the United States hold the income earned in the United States at the offices of foreign banks located mainly in the major U.S. financial centers. Moreover, these foreign banks use these deposits to purchase Government securities and make commercial loans in the United States. Consequently, the United States' increased trade and Federal deficits facilitate the growth of both sides of these foreign banks' balance sheets. The trade deficit tends to increase their deposits, while their purchases of Government securities to finance the deficit increase their assets. In the process, these foreign institutions have replaced U.S. banks in the business of acting as intermediaries between U.S. borrowers and foreign lenders.

To combat these developments, since 1985 U.S. banks have been consolidating their positions on the domestic front. With the record number of bank and thrift failures at home combined with regulatory relaxation that permits interstate banking through regional banking pacts, many U.S. international banks have reduced their foreign presence to shore up their domestic position. The number of U.S. banks with foreign offices in London, for example, is dropping. Two-thirds of the international banks departing London are U.S banks, and they are being replaced by Asian banks.[4] According to Salomon Brothers, the average foreign office loans, as a percentage of total loans for a select group of leading U.S. banks, fell from 39 percent in 1984 to 28 percent in 1988. Deposits have also declined since 1984. The average foreign office deposits as a percent of total deposits went from 44 percent to 38 percent in 1988. U.S. international banks returned home to a more familiar market with opportunities to expand their deposit base by acquiring financially troubled institutions across State lines. These efforts could only help to prevent the deterioration in U.S. banks' share of the domestic loans and deposits.

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[2] U.S. Library of Congress. Congressional Research Service. Foreign Banking in America, by William Jackson. [Washington] 1990. (Updated Regularly) CRS Issue Brief No. 90066. p. 3.

[3] James V. Houpt, *International Trends for U.S. Banks and Banking Markets*, Staff paper 156, Board of Governors of the Federal Reserve System,, May 1988. p. 11; and unpublished update of tables.

[4] Simon Lyon. Still Worth Staying. *The Banker*, November 1988. p. 82.

INTERNATIONAL BANKING IS LESS PROFITABLE

The profitability trend of U.S. foreign operations has not been good owning largely to third world debt losses. Owing largely to Third World debt losses, net income from the foreign operations of the top 25 U.S. banks was a negative $13 billion in 1987, an unusually bad year. Sour loans were mounting, though 1988 showed a strong recovery. Between 1984 and 1988, international loan charge-off, as a percentage of total net loan charge-off, went from 28 percent to 47 percent. And, international nonperforming assets, as a percentage of total nonperforming assets, went from 49 percent to 55 percent.[5]

TABLE 1. Profitability of International Activities of 25 U.S. Banks with the Largest International Business, 1980 - 1988

Year	Net Income From International Activities ($ billions)	Total Net Income ($ billions)	International Income as a Percent of Total Net Income
1980	$1.7	$4.0%	43%
1981	1.9	4.1	47
1982	1.7	4.2	41
1983	2.0	4.5	45
1984	1.7	3.5	47
1985	1.3	4.7	27
1986	1.5	4.8	32
1987	-13.1	-7.9	nm
1988	2.7	9.1	29

nm = Is not meaningful.
Source: Board of Governors of the Federal Reserve System.

U.S. BANKS HAVE SHIFTED TO EUROPE

The global distribution of foreign subsidiaries of U.S. banking organizations has shifted towards Western Europe following increased U.S. investment in Eastern and Western Europe. In 1986, 32 percent of these subsidiaries were in Western Europe. In 1988, U.S. subsidiaries in Western Europe had increased to 47 percent and the percent of U.S. bank assets in Western Europe had increased to 58 percent compared to 52 percent in 1986. In contrast, Latin America, which had 18 percent of these subsidiaries in 1986, dropped to 8 percent in 1988. This shift was due to the rush to have a European presence before the creation of the single Western European market of 1992 and Eastern Europe is now welcoming foreign direct investments. In distinction, the debt of distressed countries of Latin America discourages U.S. bank expansion in that geographic area.

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[5] Thomas H. Hanley, John D. Leonard, Diane B. Grossman, Dina I. Oddis and Alan H. Freudenstein, *A Review of Bank Performance: 1989 Edition*. Salomon Brothers. 1989. p. 98-108.

The trend toward a reduced U.S. banking presence abroad may be further explained by the type of business U.S. banks do abroad. According to the Federal Reserve Board of Governors, 75 percent of the activities of U.S. banks' subsidiaries is in commercial, investment and merchant banking. This business is strongly tied to U.S. export/import business. Only 7 percent of these banks' operations is in consumer banking abroad. U.S. exports are one of the most important determinants of U.S. foreign banking business.

BANK CAPITAL

The capital requirements of U.S. international banking institutions are no longer determined unilaterally by U.S. regulators. Capital standards are being set in multinational frameworks, such as the Bank For International Settlements (BIS) or the Basle Accord, in which the 10 leading industrial nations – the so-called Group of Ten – agreed to new guidelines for banks' risk-based capital. William Jackson points out below that these requirements are being phased in over a period of three years. Transitional standards are to be adopted by banks by year-end 1990, and final standards are to be in place by year-end 1992. Under these new standards, the amount of capital banks will be required to hold against assets will vary by type of asset. Different risk weights will be assigned to assets; for example, commercial and industrial loans will be assigned the highest-risk class, while cash will be in the lowest-risk class. Furthermore, off-balance sheet items currently requiring no capital backing will be subject to capital requirements. U.S. banks have more off-balance sheet business than most foreign banks as they are the leaders in off-balance sheet financial instruments. For example, U.S. banks have been providing standby letters of credit, interest swaps and loan sales that are not normally recorded as liabilities. The new capital requirements force U.S. banks to place these activities on the books, which increases the capital U.S. banks must raise to be in compliance with these international standards.[6]

It is clear from the new capital standard that U.S. banking institutions will face substantial difficulties, even though the U.S. banks have a higher capital level than most foreign banks. For example, in 1987 the banks of Japan and France had capital/asset ratios of 2.3 and 2.7 percent respectively, while the United States' banks had a ratio of 5.7. However, these new requirements would raise the capital levels to about 8 percent, which means U.S. banks would have the difficult task of acquiring more capital. In their efforts to meet increased capital requirements, many large U.S. banks have had to sell their headquarters and lease them back. Selling off assets is a common practice because the normal channels to raise capital have been practically closed to many international banks. For example, trying to raise capital in the equity market has been too costly to be considered by most U.S. international banks, reflecting the already declining value of their stocks due to public knowledge of their shaky domestic loans and large exposure to debt-distressed developing countries. Raising capital by issuing more equities would only depress the price of bank stocks further. And, the interest rates banks must pay on bonds have been rising as their credit ratings deteriorated over the years. However, recently U.S. international banks' credit ratings have improved slightly as they increased their loan loss reserves against their foreign loans.[7]

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[6] James J. McAndrews. How Will Third District Banks Fare in the 1990s. *Business Review. Federal Reserve of Philadelphia*, January-February 1990. p. 20.

Historically, the capital requirements of most competing banks have been lower than in the United States. However, U.S. banks' competitors are in a better position to raise capital in their countries than are U.S. banks. In Japan, for example, according to *The Economist*:

> If anything, Japan's major city (i.e., commercial) banks have turned the BIS capital requirement into an advantage. It provided them the incentive, just as they really need it, to tap Tokyo's buoyant markets for enormous dollops of capital. In less than two years the big five of Japanese banking have raised a massive Y3 trillion ($21 billion) from issuing equity and CBs (convertible bonds)....Three years still to go Japan's five largest city banks (Dai-Ichi Kangyo, Sumitomo, Fuji, Mitsubishi and Sanwa) have cleared the 8 percent hurdle already.[8]

The recent decline in the Japanese stock market has made it less favorable for raising capital. Still, like West German banks, the Japanese banks have been much more able to raise capital in their financial markets than U.S. banks, even though financial market conditions moved unfavorably for them in early 1990.

MULTINATIONAL BANKING IN SIX COUNTRIES

What financial, regulatory and related banking factors affect competitiveness in the six major countries of worldwide banking influence? These countries are: France, [West] Germany,[9] Italy, Japan, the United Kingdom, and the United States.

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[7] Barry, John M. Loan Losses Drag Bank Profits Down Sharply. *Washington Post*, March 8, 1990. p. E5.

[8] Japan's Bank and Capital Adequacy. Turning The Tables. *The Economist*, February 10, 1990. p. 76.

BACKGROUND

The twelve-nation European Community's (EC's) plans to increase competition and efficiency in many markets are evolving toward their planned completion by the end of 1992. Among the many reorganized sectors in the resulting EC will be the banking industry; it may well take the form of multiservice "universal" banks. Japan's economic growth, visible in financial form as explosive growth of its main banks, adds to U.S. banking concerns that other national financial structures might be more viable than ours in a new world economy.

The following analysis examines selected characteristics and financial performance ratios of banking institutions in France, Germany, Italy, Japan, the United Kingdom, and the United States. The experience of other countries' banks may suggest what could happen under a policy regime of U.S. universal banking. The United States has traditionally had a multiplicity of more specialized banks, which have not resembled the universal or "super" banks of concentrated European financial systems. Developing such institutions domestically would require radical restructuring of American finance; without, apparently, much firm guidance as to the advantages of doing so from indigenous European experience or the unique Japanese way of doing financial business.

In particular, among the plans of the EC with American implications is the Second Banking Directive. This Directive will essentially allow so-called universal banking, in which securities activities may be fully carried out as part of standard banking activities.[10]

Universal banking is practiced prominently in Germany, and to a lesser extent, in France. In the United Kingdom and Italy bankers own securities businesses as subsidiaries.[11] In contrast, United States and Japanese banking organizations face restrictions against blending the securities and insurance businesses into their own operations domestically.[12] The American restrictions have raised questions as to the extent to which U.S. institutions may be competitive for worldwide financial business in years to come.

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[9] The word "Germany" denotes the Federal Republic of Germany throughout.

[10] This Directive and its effects are analyzed in depth in: U.S. Library of Congress. Congressional Research Service. *Banking in "Europe 1992."* Report No. 89-456 E, by William Jackson. Washington, 1989. 14 p.

[11] U.S. Library of Congress. Law Library. *Firewalls or Chinese Walls in European Universal Banking*. Report No. 89-0094, coordinated by Kersi B. Shroff. Washington, 1989. 24 p.

COUNTRY FRAMEWORKS FOR BANKING OPERATIONS

France

French banking received extensive shakeups when it became nationalized, deregulated, and more recently privatized. Rigidities of the banking system after the first wave of nationalization of the giant banks in 1945, consolidations after 1966, and the second wave of nationalization of smaller ones in 1982-1983 were followed by the 1984 Banking Act. This Act licensed a single major class of "bank" known as a credit institution. The 1984 Act, creating full-service banks, streamlined a multiplicity of specialized institutions. Somewhat paradoxically, the banks were deregulated — while still in the public sector — and told to become competitive before their stock became offered to private owners. Privatization has not been completed.[13]

The French system experienced an analogue of the British "Big Bang" of financial integration (known as the "petit bang") in 1988, when banks were allowed to invest in securities brokers holding seats on the exchange (Bourse). They previously could sponsor and underwrite securities. French bankers may own 100 percent of securities brokers in 1990, may own real estate directly, may offer insurance through subsidiaries, and may invest in industrial companies. Some vestiges of interest rate controls and government intervention in banking still remain.[14] Government control is especially evident from the number of bank regulatory bodies:

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[12] U.S. Library of Congress. Congressional Research Service. *The Separation of Banking and Commerce*. Report No. 87-352 E, by William Jackson. Washington, 1987. 15 p.; and, *Super-Banks: Problems and Policy Choices*. Report No. 87-725 E, by William Jackson. Washington, 1987. 15 p.

[13] deBoissieu, Christian. *The French Banking Sector in the Light of European Financial Integration*. Paper presented at the Salomon Brothers Center and INSEAD Conference on European Banking After 1992, April 1989. p. 2, 24; Price Waterhouse. *The Cost of "Non-Europe" in Financial Services*. Commission of the European Communities, 1988. v. 9, p. 19-20; Bellanger, Serge. Back to the Future: Amid the Bicentennial, French Banks Look Ahead. *The Bankers Magazine*, November 1989. p. 58-60; and, Wilson, J.S.G. *Banking Policy and Structure*. New York, New York University Press, 1986. p. 135-141.

(1) National Credit Council – determines policy on banking and financing activity and issues general banking regulations;

(2) Banking Commission – monitors compliance with legislation and regulations;

(3) Bank of France – issues bank notes and has supervisory powers over credit distribution and control;

(4) Commissaries of the Government – represent the State on each central agency for each sector of credit establishments. They ensure that each central agency and its member respect the applicable banking legislation and regulations.[15]

Germany

In the German universal banking system, essentially created in the 19th century industrialization of the country, licensed banks may or may not offer all of the services they are permitted. With the regrouping of historical financial alliances after 1950, the 1961 Banking Act, as amended in 1974 and 1985 following financial crises, allows many specialized banks owned by government bodies and private entities as well as the apparently dominant Big Three banking institutions. The banks are the only underwriters and sponsors of mutual funds, and are the prominent operators of other securities operations. They may invest in insurance companies, real estate, and commercial enterprises for partial or complete control of these businesses.[16] Interest rate controls essentially do not exist in Germany today. The German banking regulatory body is the Federal Banking Supervisory Authority, which reports to the Federal Minister of Finance. In addition, the central bank (Bundesbank) exercises credit control over the banks and receives financial statements from them. Regulation of German banks appears to be somewhat consultative rather than formal, as exemplified by reliance on reports rather than on-site examinations.[17]

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[14] Broker, G. *Competition in Banking*. Paris, Organisation for Economic Co-Operation and Development, 1989. p. 156, 168-187; Neven, Damien J. *Structural Adjustment in European Retail Banking*. Paper presented at the Salomon Brothers Center and INSEAD Conference European Banking After 1992, April 1989. p. 40; Institute of International Bankers. *Global Survey of Permissible Activities for Banking Organizations*. New York, 1988. p. 12-17; Lancaster, Brian, and Andrew Hook. *The French Financial System*. New York, Federal Reserve Bank of New York, 1987. p. 6-24, 26-31; and, Pecchioli, R.M. *Prudential Supervision in Banking*. Paris, Organisation for Economic Co-Operation and Development, 1987. p. 151, 169, 189, 198.

[15] Price Waterhouse, *The Cost of "Non-Europe"*, Section 4-2, n.p.

[16] West German banks "own (or exercise proxy rights over) large blocs of shares in West German industrial enterprises and serve on the supervisory boards of German corporations. Approximately 80 percent of the largest 400 (continued)

Italy

Italian banking, having evolved over many centuries, now appears to blend public and private ownership, with heavy involvement of the government since the basic banking law of 1936 in the banking sector via complete or partial stock ownership. The Italian government – through foundations – owns six large Public Law banks. The Industrial Reconstruction Institute, a prominent government enterprise, holds controlling shares in three of the largest banks (and other financial and nonfinancial businesses). The Italian banks, who correspondingly financed the public sector, have been moving toward privatization and competition in recent years. Lack of competitiveness, general protection, and on- and off-again regulations have made these low-risk banks inefficient. Italian banks have limited exposure to financial activities other than the securities business. They are active underwriters of corporate securities and sponsors of mutual funds. They execute many securities transactions off the exchanges, being forbidden to join the exchanges. But they may not generally hold "participations" in real estate, offer insurance services, or make controlling investments in commercial or industrial enterprises directly. This separation

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(continued) German corporations have bankers on their management committees, and about 15 percent of corporate equities are estimated to be held by banks. Over half of the shares of the top 100 or so German corporations are voted by banks." Pozdena, Randall. Commerce and Banking: The German Case. *Federal Reserve Bank of San Francisco Weekly Letter*, December 18, 1987. p. 1.

[17] Hanley,Thomas H., et al. *The Universal Banks of West Germany*. New York, Salomon Brothers, 1986. p. 1-14; Wendt, Johann. The Role of Foreign Banks in International Banking. In: Baughn, William, and Donald Mandich, eds. *The International Banking Handbook*. Homewood, Ill., Dow Jones–Irwin, 1983. p. 51-53; Price Waterhouse. *The Cost of "Non-Europe"*, Section 4.2, n.p.; Rudolph, Berndt. *Capital Requirements of German Banks and the EEC Proposals on Banking Supervision*. Paper presented at the Salomon Brothers Center and INSEAD Conference on European Banking After 1992, April 1989. p. 5-6; Neven, *Structural Adjustment*, p. 40; Institute of International Bankers, *Global Survey*, p. 19-21; U.S. Department of the Treasury. *National Treatment Study: Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations*. Washington, 1986. p. 202; Wilson, *Banking Policy and Structure*, p. 152-156; and, Pecchioli, *Prudential Supervision*, p. 151, 170, 178, 179, 209.

condition. Banks remain subject to some interest rate controls. Their ultimate regulator is the Interministerial Committee on Credit and Savings, a body that controls money and credit policy. In turn, the central bank (Bank of Italy) administers the Committee's policy for banks: by licensing, examining, and monitoring them.[18]

Japan

The Japanese banking system, historically evolved from feudalism onto which industrialization and postwar American reconstruction were grafted, has been one of the most highly regulated in the free world. It is dominated by a dozen major "city" banks.

These institutions have grown both by merging, as encouraged by the Ministry of Finance, and internally by receiving large volumes of savings, issuing capital at low costs (i.e., high price-earnings ratios for their stocks), and expanding abroad. In particular, the city banks have benefitted from rapidly rising equity and real estate holdings in times of inflation. They also have benefitted from synergistic relationships with major corporations.[19]

Even though bankers may not underwrite private securities directly, many often are vitally tied in with other financial and nonfinancial businesses. City banks often act as the heart of large informal industrial groupings, including performing such services as coordinating and planning for affiliated businesses. Cross-shareholdings in such *keiretsu* groupings, though formally limited to a bank's holding 5 percent of assets of industrial corporations (10 percent before 1987), are possible to a larger extent through insurance and securities company affiliates. Banks and insurance affiliates may hold almost one-third of Japanese corporate equity.[20] (See appendix A, below.)

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[18] Cummings, Christine M., and Lawrence M. Sweet. Financial Structure of the G-10 Countries. *Federal Reserve Bank of New York Quarterly Review*, Winter 1987. p. 15-17; U.S. Department of the Treasury, *National Treatment Study*, p. 207; Institute of International Bankers, *Global Survey*, p. 35-38; Broker, *Competition in Banking*, p. 157; Neven, *Structural Adjustment*, p. 40; Price Waterhouse, *The Cost of "Non-Europe,"* n.p.; Bruni, Franco. *Banking and Financial Regulation Towards 1992: The Italian Case*. Paper presented at the Salomon Brothers Center and INSEAD Conference on European Banking After 1992, April 1989. p. 2, 11, 33; Martin, Eric. *The Financial Structure of Italy*. New York, Federal Reserve Bank of New York, 1988. p. 1-14; Wilson, *Banking Policy and Structure*, p. 185; Wendt, *Role of Foreign Banks*, p. 54; and, Pechioli, *Prudential Supervision*, p. 152, 170, 190, and 199.

[19] LeBlanc, Maureen, and Andrew C. Svarre. *The Japanese Financial System*. New York, Federal Reserve Bank of New York, 1988. p. 2-18; Hanley, Thomas H., et al. *The Japanese Banks*. New York, Salomon Brothers, 1986. p. 1-13; Wilson, *Banking Policy and Structure*, p. 193-201; and, Corrigan, E. Gerald. Trends in International Banking in the United States and Japan. *Federal Reserve Bank of New York Quarterly Review*, Autumn 1989. p. 2-4.

Many vestiges of credit and interest rate controls remain, but are gradually being replaced by deregulated competitive rates. All city and regional "ordinary banks" are governed by the Ministry of Finance under a 1981 revision of the banking laws. The Finance Ministry, through its Banking Bureau, may reexamine, receive financial reports from, and oversee any practices of, the banks. It can shut them down or provide administrative guidance in less severe disturbances. On a more contractual basis, the Bank of Japan has been the central, government, and bankers' bank under the continuing Bank of Japan Law of 1942. Institutions that maintain borrowing accounts at this Bank must submit to its examinations, send it reports, maintain required reserves within it, and receive its directives and supervisory orders.[21]

United Kingdom

British banking, evolved over half a millennium to serve the former Empire, is traditionally led by the four large clearing banks: those that clear most checks and credits through their large branch networks. They are essentially deregulated, especially in that they pay market interest rates on deposits. The banks can conduct full-service securities business through subsidiaries pursuant to the 1986 Financial Services Act, whose advent was known as the "Big Bang." One year later, a new law provided for a single basic category of banking license, emphasizing, like its securities law counterpart, the requirement that the licensed institution meet a test of being "fit and proper" to do business. Despite their historical specialization, British banking organizations may now invest in insurance, real estate, and, to a lesser extent, industrial enterprises as subsidiaries or affiliates. As supervised by the central bank (Bank of England), the British system depends heavily on informal understandings known as moral suasion, despite rather more codified regulation becoming enacted in the 1979, and especially, 1987 Banking Acts.[22]

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[20] Wendt, Role of Foreign Banks, p. 56; Leblanc and Svarre, *The Japanese Financial System*, p. 13-15; and, Pozdena, Randall J. Do Banks Need Securities Powers? *Federal Reserve Bank of San Francisco Weekly Letter*, December 29, 1989. p. 1-3.

[21] Hanley, et al., *The Japanese Banks*, p. 12; Pecchioli, *Prudential Supervision*, p. 153, 170–171, 179–180, 263; Hale, David. Expensive Stocks Make the Yen Cheap. *Wall Street Journal*, January 22, 1990. p. A14; LeBlanc and Svarre, *The Japanese Financial System*, p. 2–18; and, Terrell, Henry S., et al. The Activities of Japanese Banks in the United Kingdom and the United States. *Federal Reserve Bulletin*, February 1990. p. 44–48.

United States

The U.S. financial system is, in contrast, highly decentralized. Despite recent interstate banking, no dominant banking organizations have spread throughout America since the early Banks of the United States were liquidated. Virtually no interest rate controls or credit controls govern bank pricing decisions. And despite ongoing deregulation by statute and regulatory interpretation, U.S. banking organizations may not generally conduct insurance, real estate, or securities activities in direct full-spectrum competition with the independent businesses in these fields.

Decentralization of U.S. banking is clearly evident in the choice of regulators available to the institutions: the Comptroller of the Currency, the Federal Reserve System (the central bank, which sets liquidity or "reserve" requirements for banks), the Federal Deposit Insurance Corporation, and 50 individual State banking authorities, singly or in combination. The United States is, perhaps, unique in its suspicion of centralized financial power – and, thus, has not been characterized by the multi-service, gigantic "super banks" found in many other countries.[23]

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[22] Hanley, Thomas H., et al. *The British Clearing Banks*. New York, Salomon Brothers, 1986. p. 6–7; Price Waterhouse, *The Cost of "Non- Europe,"* p. 42–45; Mayer, Colin. *The Regulation of Financial Services: Lessons from the U.K. for 1992*. Paper presented at the Salomon Brothers Center and INSEAD Conference on European Banking After 1992, April 1989. p. 3–5; Neven, *Structural Adjustment*, p. 40; Institute of International Bankers, *Global Survey*, p. 59–63; Wilson, Banking Structure and Competition, p. 16; Kos, Dino. *The United Kingdom Financial Structure*. New York, Federal Reserve Bank of New York, 1988. 38 p.; and, Loehnis, Anthony. Financial Restructuring: The United Kingdom Experience. In Federal Reserve Bank of Kansas City. *Restructuring the Financial System*. Kansas City, 1987. p. 81–102.

[23] U.S. Library of Congress. Congressional Research Service. *The Separation of Banking and Commerce*; *Super Banks*; *Bank Diversification: Into Insurance?* Report No. 90-88 E, by William Jackson. Washington, 1990. 24 p.; *Bank Diversification: Into Real Estate?* Report No. 88-648 E, by William Jackson. Washington, 1988. 19 p.; *Glass–Steagall Act: Should Bankers be Bankers?* Issue Brief No. 90068, by William Jackson, (regularly updated). Washington, 1990.

COUNTRY COMPARISONS

Accepting the risks of oversimplification in comparing and contrasting numerous detailed structural features of each country's financial features, the following presentations summarize the major similarities and differences of the banking climate of these six countries. Tabular format is generally used.

Regulatory Authorities

The basic supervisory setting for the rules governing banks appears in table 2, below. Notice that the United States, despite its "national banking system" legislated in the 1860s, has the greatest diversity of regulators. To the extent that U.S. bankers may shop around for regulatory authority, they would appear to be less constrained than other nations' bankers.

TABLE 2. Banking Supervisory Bodies

		Institutional Coverage	
Country	Main Bodies in Charge of Prudential Supervision	Deposit-taking Institutions	Other financial Institutions
France	Banking Commission (and others; see text)	All	Finance Companies and specialized financial institutions
Germany	Federal Banking Supervisory Office; Deutsche Bundesbank	All	All except leasing and factoring companies
Italy	Bank of Italy; Interministerial Committee	All	Special credit institutes; collective investment institutions
Japan	Ministry of Finance; Bank of Japan	All	All
United Kingdom	Bank of England	All authorized deposit- taking institutions	
United States	Comptroller of the Currency;	National banks;	
	Federal Reserve System;	State member banks (and bank holding companies);	
	Federal Deposit Insurance Corporation;	State non-member banks, and insured State savings institutions;	
	State Governments	State banks, savings institutions and credit unions.	

Source: Adapted from Pecchioli, R.M. *Prudential Supervision in Banking*. Paris, Organisation for Economic Co-operation and Development, 1987. p. 24.

Asset and Liability Controls

A major feature of the competitiveness of banks – within and between nations and nonbank competitors – is the extent to which they face credit controls limiting their lending and interest rate controls limiting their ability to capture deposits. Table 3, below, indicates the major controls of these kinds. U.S. institutions, like German and U.K. ones, appear flexible in these aspects of banking.

TABLE 3. Bank Interest Rate and Credit Controls

Country	Interest Rate Controls	Credit Controls
France	On demand, time, and savings deposits	Abolished at end-1986
Germany	Abolished in 1967	None
Italy	None	With varying degrees of formality
Japan	Being phased out on time deposits	Ad hoc "window" guidance
United Kingdom	Abolished in 1971	None since 1982
United States	Demand deposits, otherwise abolished	None; briefly in 1980

Source: Adapted from Walter, Ingo. *Global Competition in Financial Services*. Cambridge, Mass., Ballinger, 1988. p. 212.

Market and Product Structure

The degree to which various financial services are associated with or separated from "the business of banking" in the six countries appears as table 4, below. Ease of foreign bank entry, as shown, is also important in determining internal competition. In each of these countries, a wide variety of nonbank competitors may offer virtually all services of the commercial banking institutions, often on the basis of greater specialization of abilities than the bankers may claim. In much of Western Europe (and the United Kingdom), for example, numerous nonbank financial institutions offer significant competition to the diversified banks. They include:

- Merchant banks
- Savings banks
- Postal and giro banks
- Credit unions
- Mortgage credit institutions/building societies
- Hire purchase finance companies
- Leasing companies
- Factors
- Life assurance companies
- General assurance companies
- Reinsurance companies
- Investment funds
- Unit trusts
- Pension funds
- Stockbrokers
- Commodities brokers
- Money brokers.[24]

All of the above, except for postal and giro banks, are, of course, prominent in the United States, and most exist in Japan.

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[24] This list is derived from Price Waterhouse. *The Cost of "Non-Europe,"* n.p. The extent of nonbank competition is also extensively documented in Germany, J. David, and John E. Morton. Financial Innovation and Deregulation in Foreign Industrial Countries. *Federal Reserve Bulletin*, October 1985. p. 743-753; and, Kapstein, Ethan B. Resolving the Regulator's Dilemma: International Coordination of Banking Regulations. *International Organization*, Spring 1989. p. 323-347.

TABLE 5. Share of Five Largest Banks in Assets of All Banks, End-1984

Country	Market Share
France	
-- total	52%*
-- domestic	48*
Germany	
-- total	26
Italy	
-- total	36
-- domestic	32
Japan	
-- total	33
-- domestic	28
United Kingdom	N.A.
United States	
-- domestic	13

* At the end of 1987.

Source: Broker, G. *Competition in Banking*. Paris, Organisation for Economic Co-operation and Development, 1989. p. 200.

What Can Banks Do?

Table 6, on the next page, indicates the major diversification potentials available to banking organizations in the five foreign countries. U.S. bankers perform almost none of these activities. In other countries, and not only in the United States, industrial control over banks may be discouraged. Table 7, below, further indicates the degree of separation of banking from industry in each of these nations. The Japanese limits on banking activities on their face appear to be about the same as the U.S. limits. Recalling the clustering of bank-insurance-industrial interests in Japan, however, makes one suspicious of the formal limits. (See appendix A.) If the ability to form commercial – industrial – financial alliances is considered a significant way of attracting new international business, then the United States appears out of step in these tables. But the banks in these complexes may be unwilling to finance competitors (especially in Japan) and may not want new banking business from many outside firms; placing U.S. bankers, who are willing to finance almost all businesses if the price is right, somewhat ahead of their foreign competitors.

TABLE 6. Permissible Activities for Banking Organizations in Major Financial Centers*

Country	Securities	Insurance	Real Estate	Industrial Investment
France	Unlimited	Unlimited, usually through subsidiaries	Unlimited	Permitted, subject to regulatory approval of interests in excess of 10%[a]
Germany	Unlimited	Unlimited through subsidiaries	Unlimited through subsidiaries	Permitted, subject to limits based on bank's capital[a]
Italy	Unlimited, but not permitted to execute transactions on exchanges	Not permitted	Generally limited to holding bank premises	Permitted on a non-permanent basis in connection with merchant banking activities[b]
Japan	Limited; but a U.S. or other non-Japanese bank can own up to 50% of a full-service securities affiliate	Not permitted	Generally limited to holding bank premises	Limited to holding a 5% interest[b]
United Kingdom	Unlimited, usually through subsidiaries	Unlimited through subsidiaries	Unlimited	Permitted subject to consultations with the Bank of England[c]

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[*] Under the laws and regulations of the five countries surveyed, U.S. banking organizations may engage in the permissible activities listed to the same extent as local banks.

[a] Investments in banks by industrial firms are not prohibited, but such investments are generally not made.

[b] Investments in banks by industrial firms above a certain limited percentage are not generally permitted.

[c] No statutory prohibition, but the Bank of England has indicated it would not favor controlling investments by industrial firms in major banks.

Source: Institute of International Bankers. *Global Survey of Permissible Activities for Banking Organizations in Major Financial Centers Outside the U.S.* New York, 1988. p. i.

TABLE 7. Predominant Form of Banking–Commerce Integration

Country	Bank Ownership of Commerce*	Common Holding Company**	Generally Limited Integration***
France		X	
Germany	X		
Italy			X
Japan			X
United Kingdom			X
United States			X

* Commercial ownership of banks is not common

** The typical form of integration is for a single holding company to have significant ownership interests in both banks and commerce.

*** In general, there are no controlling ownership affiliations between individual banks and commercial firms.

Source: Cummings, Christine M., and Lawrence M. Sweet. Financial Structure of the G–10 Countries. *Federal Reserve Bank of New York Quarterly Review*, Winter 1987. p. 15.

Prudential Controls on Assets

Virtually all countries maintain standards for liquidity and asset quality of their banking institutions. The central banks set liquidity ("reserve") requirements, ostensibly for the purpose of monetary policy, while other authorities may set limits on exposure of any institution to loss from lending to one borrower or groups of related borrowers. Tables 8 and 9, below, compare these features of bank regulation. U.S. institutions do not appear to be significantly disadvantaged – to the extent that asset controls limit internal viability of lenders – in them.

TABLE 8. Prudential Controls on Liquidity

Country	Statutory Requirements	Guidelines	Monitoring	Scope of Control
France	X	Foreign-currency operations		Domestic branches
Germany	X			Consolidated domestic offices and foreign branches
Italy			X	Consolidated domestic offices and foreign branches
Japan		X		Consolidated domestic offices and foreign branches Domestic branches
United Kingdom			X	Worldwide consolidation
United States		X	X	

Source: Pecchioli, R.M. *Prudential Supervision in Banking*. Paris, Organisation for Economic Co-operation and Development, 1987. p. 94.

TABLE 9. Control on Individual Large Exposures

Country	Modality of Control*	Coverage**	Major Recent Changes
France	FL	W	Limits tightened in 1984
Germany	FL	W	Limits tightened in 1976 and 1985
Italy	FL		
Japan	FL		Limits redefined in 1982
United Kingdom	FL	W	Regulations tightened in 1983 and 1985
United States	FL,G	W	Regulations revised in 1983

* FL denotes formal limits; G denotes guidelines.

** W denotes worldwide consolidation of reporting banks.

Source: Pecchioli, R.M. *Prudential Supervision in Banking*. Paris, Organisation for Economic Co-operation and Development, 1987. p. 76.

What Is Bank "Capital"?

Despite all of the regulation of bankers and the general belief that they should conduct their activities so as to avoid losses, they can and do become insolvent. One way to lessen their chances of failing is clearly to require a cushion of capital, to back up the integrity of depositors' funds by its availability to absorb losses. Under existing regulatory standards these six countries have had varying requirements for not only the amount, but even the composition, of the cushion. Table 11, below, presents an overview of what had officially been considered bankers' capital in these six countries. The U.S. position in this table appears to lie somewhere in between the extremes of French permissiveness and ostensible German strictness (but see below for German accounting practices).

TABLE 10. Basic Components of "Capital" for Solvency Purposes

Country	"Core" Capital [a]	Capital-like Instruments [b]	Asset Revaluation Reserves [c]	Undisclosed Reserves [d]	General Provisions	Subordinated Debt [e]
France	Yes	Yes	Yes	NP	Yes	Yes
Germany	Yes(*)	Yes	NP	No	No	No
Italy	Yes	Yes	Yes	NP	Yes	No
Japan	Yes(*)	N.A.	NP	No	Yes	No
United Kingdom	Yes	N.A.	Yes	Yes	Yes	Yes
United States	Yes(*)	N.A.	NP	NP	Yes	Yes

N.A. = Not available in the source.

NP = Legal or accounting rules do not permit the formation of such reserves.

[a] Paid-up capital – including irredeemable preference shares and preference shares mandatorily convertible into ordinary shares, share premium, statutory and legal reserves, and retained profits. In some countries – indicated with (*) – the inclusion of some of these elements is made subject to certain conditions or other minor elements are also allowed.

[b] Mainly participation certificates, and long-term redeemable preference shares.

[c] To the extent that they are disclosed in balance sheet.

[d] Provided that they are quantified and accepted by the supervisor.

[e] The inclusion of subordinated debt may be subject to specific limits.

Source: Pecchioli, R.M. *Prudential Supervision in Banking*. Paris, Organisation for Economic Co-operation and Development, 1987. p. 108.

But the longstanding international dispute over what constitutes capital for banks may have been settled by a multinational agreement. Beginning with a U.S.-U.K. agreement reached in 1987, based on the Bank of England's risk-based standards for capital adequacy, then extended to Japan and finally to become applicable to the entire EC, the new standards for bankers' capital are summarized in table 10 – as they apply to U.S. national banks. Contracts and exposures of banks to loss potentials off-the-balance-sheets must be converted to risk equivalents for these standards as well.

TABLE 11. Risk-based Capital Standards
A. Assets

Percentage of Asset Required in Risk-based Computation	Major Asset Class
Zero	Cash, due from central banks, claims guaranteed by central governments, gold.
20%	Assets collateralized by Government securities or conditionally guaranteed by central governments; claims on depository institutions; cash in process of collection; obligations and guarantees of public-sector entities.
50%	Revenue bonds; credit equivalents of interest rate and exchange rate contracts that are off-balance sheet items; assets secured by residential first mortgages.
100%	All other claims on private obligors [bonds, loans]; government obligations paid solely by private parties; fixed assets and real estate; investments in subsidiaries; all other assets.

B. Definition of Capital

Capital components are distributed between two categories (Tier 1 and Tier 2). Tier 2 capital elements will qualify as part of a bank's total capital base up to a maximum of 100% of that bank's Tier 1 capital. Beginning December 31, 1992, the minimum risk-based capital standard will be 8.0%.

Definition of Capital

Tier 1:

- common stockholders' equity;
- noncumulative perpetual preferred stock and related surplus;
- minority interests in the equity accounts of consolidated subsidiaries.

(continued)

TABLE 11. Risk-based Capital Standards
B. Definition of Capital -- continued

Tier 2:

- cumulative perpetual, long-term and convertible preferred stock, and related surplus;
- perpetual debt and other hybrid debt/equity instruments;
- intermediate-term preferred stock and term subordinated debt (to a maximum of 50% of Tier 1 capital);
- loan loss reserves (to a maximum of 1.25% of risk-weighted assets).

Deductions from Capital:

From Tier 1:

- goodwill and other intangibles, with the exception of identified intangibles that satisfy the criteria included in the guidelines.

From Total Capital:

- investments in unconsolidated banking and finance subsidiaries;
- reciprocal holdings of capital instruments

Transitional Definition

During a transition period beginning December 31, 1990, all national banks are expected to maintain a capital to risk-weighted asset ratio of 7.25%, of which at least 3.25 percentage points must consist of Tier 1 capital. In other words, during this period up to approximately 4 percentage points of the 7.25% capital ratio may consist of Tier 2 capital. Also during this period, the sublimit on loan loss reserves will be 1.5% of risk-weighted assets.

Source: Summary of OCC Final Rule on Risk-Based Capital. *BNA's Banking Report*, January 30, 1989. p. 300-302. (The categories are actually very detailed; see the original.)

In addition to these risk-adjusted guidelines, as they become adopted by each country with perhaps some modifications;[26] more traditional capital analysis focuses on how much actual owners' investment (variously known as equity, stock, or net worth) backs up the credit standing and asset vulnerability of banks. This latter measure is known to industry followers as "leverage," or in Europe as "gearing." It is expressed generally as the percentage of assets that each institution's net worth represents. Such standards – while clearly related to Tier 1 of risk-adjusted bank capital – may be required in addition to the risk-based ones. In the EC, for example, the Second Banking Directive requires bankers to meet both risk-based and leverage capital standards to conduct Community-wide, full-service banking. In addition to, but coordinated with, its Banking Directive, the EC's Own Funds Directive addresses the leverage ratio, while its Solvency Ratio Directive addresses capital elements as related to asset risk.[27] Meanwhile, U.S. banking institutions may also be expected to meet at least a 3 percent leverage ratio, rising as their perceived riskiness is less than that of the best-managed banks to perhaps as much as 10 percent.[28]

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[26] Capital Measurements and Capital Standards. *The World of Banking*, January 1988. p. 16-24; Proposals for International Convergence of Capital Measurements and Capital Standards. *Issues in Bank Regulation*, Winter 1988. p. 3-13; and, Devinney, Timothy M. 1992: What Will It Mean for Financial Institutions? *Issues in Bank Regulation*, Spring 1989. p. 13.

Examining the financial position of the banks themselves, their capitalization strengths emerge in table 12, below. The capital-values are as publicly disclosed, and may underestimate true net worth because of "hidden" reserves used to smooth out bank earnings in bad years. Higher leverage (unity divided by capital/asset ratio) is evident for the French and German banks than for the Italian and British institutions. That is, a given base of capital supports far greater assets in France than across the Channel in Britain. The Japanese institutions have had very small (published) capital bases; in sharp contrast to the restrictive U.S. ratios that are the most severe for all banks and the second most so for the top banks. The extent to which leverage or "gearing" (as it is called in Europe) related to these capital conditions appears in table 13, on the next page). Asset expansion has clearly been easy in Japan and rather hard in the United States for the leading bankers on this basis. The risk-based capital standards and the leverage capital standards are both designed to bring down the gearing ratios of the most aggressive bankers worldwide. Relative to the rest of the world's banking practices, the capital standards themselves might not seem to unduly hinder U.S. bankers.

TABLE 12. Capital/Asset Ratios of Banks

Country	Top 5 Banks, 1987	All Banks, 1986
France	3.1%	2.7%
Germany	3.1	3.7
Italy	4.0	5.3
Japan	2.5	2.3
United Kingdom	5.3	5.2
United States	4.6	5.7

Source: Bruni, Franco. *Banking and Financial Deregulation Towards 1992: The Italian Case*. Paper presented at the Salomon Brothers Center and INSEAD Conference on European Banking After 1992, April 1989. Table 12, n.p.

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[27] U.S. International Trade Commission. *The Effects of Greater Economic Integration Within the European Community on the United States*. Washington, 1989. p. 5-13.

[28] Greenspan Says Weaker Banks Expected to Meet 4 to 5 Percent Leverage Ratios. *BNA's Banking Report*, January 15, 1990. p. 50-51.

TABLE 13. Assets Supported by A Given Unit of Disclosed Bank Capital Top Five Banks, 1987

Country	Gearing Ratio
France	32
Germany	32
Italy	25
Japan	40
United Kingdom	19
United States	22

Source: Computed from table 12: 100 percent (of assets) are divided by the capital/asset percentage.

The United States, again, stands somewhat alone in the world of banking in its recent treatment of elements of earnings or asset values used to build capital internally. Bankers in most other countries may underreport their profits by using unrealized capital gains to build various "reserves." They may conceal reservoirs of earnings, ready to draw down in case of need, by understating assets and/or overstating liabilities. Specific instances are the hidden reserves of Germany and Japan, which are not allowed in the United States and have not been used by the U.K. clearing banks since 1971.[29] These reserves exist as net worth even though they do not necessarily count towards published bank capital.

In Germany, two valuation methods can create hidden reserves: "lower of cost or realizable value" of assets and additional reserves "to safeguard against the special risks pertaining to banking." The former allow for marking assets down-to-market values, are obligatory, and provide tax benefits; they need not be rewritten upward if asset values rise. The latter, voluntary in nature, allow under-valuation of loans and securities but provide no tax benefits.[30]

In Japan, too, undervalued assets such as equities of affiliates, industrial stocks generally, and real estate, which have appreciated rapidly, have not been reported as capital. Marking these holdings to realizable market values could, perhaps, double or triple the accounting net worth of major Japanese banks. Indeed, recognition of these unreported profits may be one reason why the stock market price-to-earnings ratios of Japanese city banks appear astronomical. Japan has insisted that its banks be allowed to count 45 percent of such items in their published risk-based capital accounts — thereby making them sufficiently capitalized and, according to at least one observer, overcapitalized relative to the Japanese economy.[31] Japanese bank losses on international loans may also be tax-deductible, including potential losses of a small percentage of such loans that have not actually been realized.[32]

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[29] Guttentag, Jack, and Richard Herring. Disclosure Policy and International Banking. *Journal of Finance*, March 1986. p. 91.

[30] Hanley, et al., *The Universal Banks of West Germany*, p. 12–13; and, Pecchioli, *Prudential Supervision*, p. 245–246.

The other countries' situations fall somewhat in between the above two countries and that of the United States, in which no hidden reserves are allowed while the Tax Reform Act of 1986 and regulatory actions discourage reported asset reserves.[33] In France, bankers can write down securities losses and bad loans (when they institute proceedings against debtors). They may make provisions against unrealized losses on international financing.[34] In Italy, bankers may create general credit risk reserves, receiving tax benefits from them up to a 5 percent level. In the United Kingdom, an institution's own directors and auditors determine specific asset losses and general provisions against classes of assets. The latter, in turn, may be counted in reported capital according to determinations of the Bank of England.[35]

Complicating comparisons of capital adequacy across nations might be the varying degree to which national authorities apply consolidation of banking assets as the numerator of supervisory capital ratios. (A subsidiary of a bank might escape capital regulation because it has separate legal existence and might operate in an entirely unregulated industry.) Table 14 (on the next page) indicates that few significant variations in cross-national banking supervision of consolidated accounts exist for their financial operations. Bank account consolidation thus does not appear to be a major difference among these nations; U.S. practice does not place U.S. bankers at a disadvantage.

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[31] Hanley, et al., *The Japanese Banks*, p. 13; and, Hale, Expensive Stocks, p. A14.

[32] Pecchioli, *Prudential Supervision*, p. 248.

[33] U.S. Library of Congress. Congressional Research Service. *Bank Lending to the Third World: Risk Considerations*. Report No. 88-525 E, by William Jackson. Washington, 1988. p. 13-25; and, *Bank Soundness in Light of the Tax Reform Act of 1986 and Possible Glass–Steagall Act Repeal*. Report No. 88-118 E, by Walter W. Eubanks. Washington, 1988. p. 2–7.

[34] Pecchioli, *Prudential Supervision*, p. 244–245.

[35] Ibid., p. 254–255.

TABLE 14. Supervision Based on Consolidated Accounts

	Domestic Subsidiaries				Subsidiaries Abroad		
Country	Bank	Nonbank Financial	Non-Financial	Branches Abroad	Bank	Nonbank Financial	Non-Financial
France	yes	yes	yes	yes	yes	yes	yes
Germany	yes	yes	no	yes	yes	yes	no
Italy	yes	yes	no	yes	yes	yes	no
Japan	yes	yes	yes	yes	yes	yes	yes
United Kingdom	yes	yes	*	yes	yes	yes	*
United States	yes	yes	yes	yes	yes	yes	yes

Note: The threshold of application of consolidation varies from country to country. Nonbank financial excludes insurance companies.

* Coverage depends on the scale and nature of the business.

Source: Pecchioli, R.M. *Prudential Supervision in Banking*. Paris, Organisation for Economic Co-operation and Development, 1987. p. 30.

IN CASE OF TROUBLE

Bankers do occasionally experience the unthinkable: financial distress. All major nations have placed financial safety nets under their banks in various forms to prevent such headaches from becoming national economic disasters.

The most obvious protection is deposit insurance — a form of governmental protection that reassures account-holders that the worst will not happen to them regardless of losses experienced by their bank. Italy has recently adopted this protection. Table 15, below, portrays the major features of deposit insurance. The entire basis of deposit insurance in the EC may well be harmonized by a Deposit Insurance Directive. Meanwhile, the U.S. safety net for depositors appears to be the most generous, at least for deposits financially within U.S. boundaries.

TABLE 15. Deposit Bank Guarantee Programs

Country	Insurer	Coverage	Foreign Banks' Branches	Insurer
France	Association of French Bank (nongovernment)	400,000 francs (U.S. $70,400), but only 200 million francs ($35 million per bank)	Mandatory*	Healthy banks provide liquidity to troubled banks and finance bailouts
Germany	Federal Association of German Banks (nongovernment)	30% of bank capital per depositor	Optional	Emergency liquidity provided by central, public and private banks
Italy	Deposits Protection Scheme (nongovernment)	Up to 200,000,000 liar ($161,300) then 90% to 1 billion lira ($806,500) then 80% to 3 billion lira ($2.4 billion)		Weak banks merged into stronger ones
Japan	Deposits' Insurance Corporation (federal)	10,000,000 yen ($68,000) per depositor	Not covered	Weak banks merged into stronger ones
United Kingdom	Deposit Protection Scheme (federal)	75% of deposits up to 20,000 pounds ($34,200) per depositor	Optional	
United States	Federal Deposit Insurance Corporation	$100,00 per depositor	Mandatory*	

* Mandatory if the branch accepts retail deposits.

Source: American Bankers Association. *International Banking Competitiveness - Why It Matters*. Washington, 1990. p. 83.

Before deposit insurance is required upon collapse, failing banks grasp for lifelines from their countries' central banks and/or their competitors. There is a lender of last resort for the bankers in each country.[36] In France, the Bank of France may lend directly to a troubled bank, and/or require its shareholders or the entire banking industry to shore it up. In Germany, a joint commercial-bank-Bundesbank entity known as the Liko-bank lends to insolvent institutions. The Federal Bank Supervisory Office may suspend payments by failing firms, or call upon the Federal Government for assistance if its failure seems likely to present a danger to the economy or payments system. In Italy, the Bank of Italy may lend directly to distressed banks, suspend its payments, or arrange for its competitors to fund it and subsidize their costs of doing so. In Japan, the Bank of Japan may lend an insolvent bank funds at special rates when its collapse would present risk to the financial system. The Deposit Insurance Corporation may also extend low-rate credit to an acquirer of a failing bank. And in the United Kingdom, the Bank of England may arrange financial "lifeboats" by lending to an individual institution or arranging a merger for it — although this situation is not normal practice. Routine access to Bank of England credit is restricted to Government securities dealers known as "discount houses"; it is not available except in emergency cases to licensed banks.[37]

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[36] "In the U.S. the authorities (FDIC and the Fed), on three notable occasions, have provided liberal assistance to major insolvent banks: Franklin National in 1974, First Pennsylvania in 1980, and Continental Illinois in 1984. In each case the authorities guaranteed both insured and uninsured deposits. Moreover they advanced loans at subsidized rates. Apparently the Federal Reserve has switched to a policy of bailout reflecting a concern over the potential effects on the financial system and on the reputation of the authorities of allowing a major bank to fail.

"The Bank of England followed similar policies in the 1974Fringe Bank rescue and the 1984 Johnson Matthey affair. In 1985, the Bank of Canada arranged for the purchase by the major chartered banks of the assets of two small insolvent Alberta banks and compensation in full of all depositors."

"By contrast to the Anglo-Saxon experience, the German Bundesbank allowed the Herstatt bank to be liquidated in 1974 but provided assistance to the market."

Bordo, Michael, D. The Lender of Last Resort: Some Historical Insights. In: Federal Reserve Bank of Chicago. *Banking System Risk: Charting a New Course*. Chicago, 1990. p. 188.

[37] Cummings and Sweet, Financial Structure, p. 24; and, Pecchioli, *Prudential Supervision*, p. 260–263, 267.

In the United States, the Federal Reserve will lend to depository institutions in trouble, transferring much of the costs of rescuing them on a permanent basis to the Federal Deposit Insurance Corporation. If necessary, a leading bank in trouble may borrow from a consortium of its competitors under Government sponsorship. The Federal Deposit Insurance Corporation may also subsidize the acquisition of a collapsed bank by a healthier one.[38] The United States thus does not fall behind by this measure of depositor confidence in its banks, which may be vital for new international business.

Financial Results

The banking institutions most active internationally – the largest ones in each country – have experienced mixed results under disparate regulations and traditions. Table 16, below, presents some financial results for these institutions in recent years, as averaged to lessen the impact of any one year's unusual factors.

TABLE 16. Selected Financial Data for Leading Banks
1985–1987 Averages

Country	Number of Leading Banks	Asset Growth*	Profitability**	Productivity***
France	7	2.2%	12.0%	2.7%
Germany	3	6.4	10.9	2.2
Italy	N.A.	N.A.	N.A.	N.A.
Japan	8	12.0	12.7	0.9
United Kingdom	4	2.9	8.4	3.7
United States	9	4.3	4.5	3.1

* Internally compounded growth rate of consolidated total assets less contra accounts in local currency.

** Net income as percentage of average equity, as reporyted.

*** Operating expenses as percentages of average earning assets.

Source: Calculated from Hanley, Thomas H., et al. *European Banking Integration in 1992*. New York, Salomon Brothers, 1987. p. 75, 76, 79, 81, 82, 84, 86, 87, 90, 91, 94, 109.

In table 16, the asset accumulation of the fast-growing Japanese city banks has almost doubled the pace of the German banks. The lower French and U.S. rates of growth exceeded that of the sluggish United Kingdom, even given the latter's inflation. And despite the purported low profitability of the leading Japanese banks, they appear very profitable in their highly leveraged equity returns – more so than the rich French institutions. The German banks have seen acceptable profitability, perhaps understated by their reserves, while U.K. and, especially, U.S. institutions were hard hit by providing for reserves to write down Third World loans and thus fared poorly.[39] And by another operating characteristic – a measure of productivity not affected by currency variations in which the lower the ratio the better – the operating expense ratio, the Japanese bankers appear the best. Their (noninterest) cost control is far superior to the German and French banks' ratio. Even worse cost control appears for the U.S. institutions in this statistic. Only the British clearing banks had a higher cost ratio. By all of these measures, the largest U.S. banking organizations will have to improve if they wish to match their foreign counterparts in the future.

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[38] U.S. Library of Congress. Congressional Research Service. *Bank Bailouts: Open-Bank Assistance by the Federal Deposit Insurance Corporation*. Report No. 86-1041 E, by William Jackson. Washington, 1987. p. 4–8.

IMPLICATIONS FOR AMERICAN FINANCIAL LEGISLATION

The banking influences of "Europe 1992" and Japanese financial developments extend to America as well. The largest European banks may become stronger competitors, within and beyond U.S. borders after 1992. No end in sight is visible for Japanese financial growth. As coordinated with safety and soundness standards for bankers' capital adequacy, the forces for "harmonization" of world banking seem likely to strengthen. The clearest case of this convergence is the risk-adjusted capital standard extended to most major banks in the world.

If U.S. banks increasingly enter all kinds of banking/securities activities in Europe, their EC experience may increase pressures to increase U.S. banks' international competitiveness by having Congress relax or repeal the Glass-Steagall Act preventing them from this activity here. Such changes are sought by those who are concerned with the relative decline of America's share of major free world banking in recent years. (See table 17, below.) Related legislation that might become liberalized could include the Bank Holding Company Act, the International Banking Act, the National Banking Act, the Federal Deposit Insurance Act, and securities laws generally, under this approach. The United States and (nominally) Japan would remain the only major nations isolating banking and capital markets generally, if "Europe 1992" banking comes to fruition.

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[39] Despite U.S. provisions on a massive scale – which are not generally tax deductible – further set-asides may be required if U.S. bankers are to match the "removal" of Third World loans from the books of their European counterparts. See appendix B.

TABLE 17. World Distribution of Major Bank* Assets
(Millions of 1987 U.S. Dollars)

	1980	1987
United States		
Total major bank assets	$978,376	$878,313
Average per bank	54,354	73,193
Percent of world market	16.4%	8.6%
European Economic Community		
Total major bank assets	$2,672,661	$3,906,261
Average per bank	55,680	79,720
Percent of world market	44.7%	38.3%
Japan		
Total major bank assets	$1,432,278	$4,097,128
Average per bank	59,678	132,165
Percent of world market	23.8%	40.2%

* A major bank is defined as one that possesses more than $30 billion in assets.

Source: Devinney, Timothy M. 1992: What Will It Mean for Financial Institutions? *Issues in Bank Regulation*, Spring 1989. p. 12. Part of the decline in the United States' share results from depreciation of the U.S. dollar against the yen and some other currencies; bank mergers have also raised the average per bank.

But such pressures need not inevitably prevail. Banking, as practiced in the countries reviewed here, produces varied results for its practitioners. The degree to which financial institutions combine banking with other businesses seems to be swamped by other factors such as regulations, traditions of doing business, and, of course, inflation, in determining the internal success of the leading institutions. The French, German, and, especially, Japanese banking leaders do seem to benefit from lower capital coverage of their assets, but their advantage could vanish after 1992. It is believed that the French and Italian banks may be handicapped, by government ownership and local investor distrust, from raising capital to meet the new standards.[40]

Meanwhile, U.S. money center banking institutions have little guidance as they seek to compete in the new worldwide markets, especially in "retail" banking, in the face of higher costs of capital and other disadvantages. U.S. multinational banks have drawn back from European operations generally – especially from the securities business in London. Some have also sold off extensive banking operations on the Continent in the face of cultural barriers.[41] They have had little success in penetrating the internal Japanese banking market. They are well aware that adding many new assets to their balance-sheets — or even credit commitments off the balance sheets — could drive up their required amounts of capital under the "leverage" and "risk-adjusted" regulatory standards. Simultaneously, low prices for bank stocks and high interest rates for non-stock financing place them (and their British counterparts) at a financial disadvantage to their Japanese analogues — even if banks face equal capital ratio requirements worldwide — in any expansion of activities.[42] And as shown above, the largest U.S. (and British) banks need to practice cost control if they are to be competitive over the long-term in worldwide markets which may come to include domestic ones.

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[40] Hanley, et al., *European Banking Integration*, p. 48–49.

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[41] Ibid., p. 55–56; U.S. Banks Offices Dwindle in London as Japan's Grow. *American Banker*, February 26, 1990. p. 10; and, Statement of Ernest-Moritz Lipp in: U.S. Congress. House. Committee on Banking, Finance, and Urban Affairs. Subcommittee on Financial Institutions Supervision, Regulation, and Insurance. *Oversight Hearings on European Community's 1992 Program*. Hearings. Washington, U.S. Govt. Print. Off., 1989. p. 196. (Serial no. 101–53.)

[42] New Capital Rules Exacerbate Existing Competitive Problems for Money Centers. *BNA's Banking Report*, August 29, 1988. p. 343-345; Hanley, et al., *European Banking Integration in 1992*, p. 46-51; U.S. International Trade Commission, *Effects*, p. 5-13–5-18; Japanese Banks Poised for 1992 as U.S. Banks Retreat from Europe. *BNA's Banking Report*, October 2, 1989. p. 488-489; Paisley, Ed. Glass-Steagall Boosters Point to Europe. *American Banker*, October 31, 1989. p. 8; and, Carletti, Silvano, and Susan Aaronson. Which Banks Can Bank on 1992? *Bankers Magazine*, August 1989. p. 20-27.

APPENDIX A. "ISOLATION" OF FINANCE FROM INDUSTRY IN JAPAN

> A system of stable shareholdings binds most major Japanese corporations, their subsidiaries, suppliers, and sales corporations with one or two lead banks and affiliated mutual life insurers. Financial institutions, mostly banks and insurance companies, own a major and rising share of equities traded on the Tokyo Stock Exchange. Financial institutions appear to be even more important among shareholders of large Japanese companies: of 78 large firms studied 10 years ago, 61 were more than 75 percent owned by financial institutions. The large firms in turn have set up or bought into smaller companies upstream and downstream — some in the same line of business, others in marketing, and still others in diverse fields such as real estate.
>
> Differences in the performance of Japanese firms within and without a *keiretsu*, the enterprise group as just defined, support the hypothesis that the group functions as a social contrivance for reducing aggregate risk costs for relatively risk-averse member firms, with financial institutions acting as insurers. . . .
>
> The risk-sharing arrangement costs the corporation money and flexibility in good times but offers support in bad times. Corporations must maintain a high and stable outstanding debt to their respective main banks. The short-term loans are governed by conditions that give Japanese banks rights to take assets, seize collateral or offset holdings to counter possible losses in event of threatened insolvency even though there is no literal default. When corporations are "heavy borrowers," their bank has considerable influence and, in some cases, veto power over capital spending plans. In the extreme, a firm in financial difficulties may suddenly find several of its top executives replaced by bank personnel.
>
> When a corporate borrower faces difficulty, the main bank not only coordinates efforts by affiliates to increase purchases, to stretch receivables, or to accept transfers of lifetime workers, but also renders more than its share of financial assistance. . . .
>
> Financing and risk-sharing within the group of affiliated firms permits higher leveraging, especially for rapidly growing firms....[43]

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[43] McCauley, Robert N., and Steven A. Zimmer. Explaining International Differences in the Cost of Capital. *Federal Reserve Bank of New York Quarterly Review*, Summer 1989. p. 21.

APPENDIX B. THIRD WORLD LOAN RESERVE PROVISIONS

> Analysts in the United States and Europe insist U.S. banks that have comparatively low reserves are at a decided disadvantage when it comes to stock price performance and debt ratings. Moreover, analysts say that some of these banks could eventually experience higher funding costs. . . .
>
> With the exception of J.P. Morgan & Co., and Bankers Trust Co., which are 100% and 85% reserved respectively, major U.S. banks are now lagging behind prevailing international reserve levels.
>
> Citicorp is reserved for 38% of its Third World exposure; Manufacturers Hanover Corp., 41%; Chase Manhattan Corp., 53%; and Chemical Banking Corp., 45%.
>
> The higher provisions now prevailing in Europe put increased pressure on major U.S. banks to strengthen their reserve levels....
>
> British banks have a decided tax advantage in increasing their reserves, because they can write off some of their provisions against their profits. The Bank of England, in a matrix that recomends minimum provisioning levels for British banks, has set new guidelines of about 50%, levels the tax authorities should follow for tax relief. U.K. banks were only provisioned an average of 30% to 35% at yearend 1988.
>
> U.S. banks can receive tax benefits only when they write off their LDC loans, not when they take provisions for them.
>
> Bryan Crossley, chief analyst at Merrill Lynch & Co. in London, said that the underprovisioned banks will "suffer in terms of share price performance and rating.
>
> William Vincent, banking analyst at UBS Phillips & Drew, a unit of Union Bank of Switzerland, is additionally concerned that "the cost of market money for the low- provisioned banks is going to rise. It may be over time, and may be by only $^1/_{64}$th or so, but the market will recognize the greater risks."
>
> While the Japanese banks, with more than $35 billion in Latin American debt, have made only low loan-loss reserves, they are broadly insulated by the massive size of their shareholders' funds, as the world's most heavily capitalized banks, analysts say.[44]

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[44] Evans, John. U.S. Banks Pressed to Lift LDC Reserves. *American Banker*, February 26, 1990. p. 1, 10.

FEDERAL TAXATION OF DOMESTIC OPERATIONS OF U.S. BANKS

This part of this report addresses the issue of whether or not domestic operations of U.S. commercial banks are taxed differently from other U.S. corporations.[45] Since the passage of the Tax Reform Act of 1986 (the Act), no new laws have been passed that significantly affect the effective tax rate of U.S. commercial banks relative to other U.S. corporations.

Advocates of the Tax Reform Act of 1986 argued that the tax system should be neutral concerning economic decision making. They claimed that the market forces of supply and demand could more efficiently allocate resources than the tax system; consequently, tax preferences for specific industries or sectors should be eliminated or curtailed. They argued that the elimination or reduction of tax preferences would broaden the tax base and permit lower marginal tax rates; consequently, economic resources would be allocated more efficiently.

Before the passage of the Tax Reform Act of 1986, numerous specific tax preferences were given to commercial banks and other financial institutions because of their unique characteristics and the regulatory context in which they operated. These tax preferences reduced the effective tax rate on domestic operations of U.S. commercial banks well below the average effective tax rate on domestic operations of all U.S. businesses. But financial deregulation had been reducing both the differences between commercial banks and other financial institutions and between the financial services industry and other industries.

The Tax Reform Act of 1986 increased the effective tax rate on domestic operations of U.S. commercial banks. *Currently, U.S. commercial banks pay an effective tax rate on their domestic operations that is approximately equal to the average effective tax rate paid by all other U.S. corporations on their domestic operations.* The three primary tax preferences that the Tax Reform Act of 1986 curtailed or eliminated concerned bad debt reserves, the deduction for interest to carry tax exempt obligations, and special rules for net operating losses.

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[45] The primary source of information for this analysis was U.S. Library of Congress. Congressional Research Service. *Taxation of Commercial Banks in the Tax Reform Act of 1986 (Conference Agreement)*, Report No. 86-933 E, by James M. Bickley. Washington, October 22, 1986. 6 p. Two other sources for this memorandum were U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1986*. Washington, U.S. Govt. Print. Off., 1987. p. 549-568: and *U.S. Master Tax Guide--1990*. Commerce Clearing House, Inc. November 1989. p. 506-507.

BAD DEBT RESERVES

Before the Tax Reform Act of 1986, commercial banks and other business taxpayers could use either the specific charge-off method or the reserve method in accounting for their bad debts for the Federal income tax. The specific charge-off method took an expense for bad debts at the time the debts were determined to be worthless. The reserve method permitted taxpayers to deduct increases in reserves for expected future losses when the loans were make. The specific charge-off method and the experience-based reserve methods were allowed to all taxpayers with bad debt losses (whether financial institutions or not). Commercial banks could use an additional reserve method, the percentage of eligible loans method, which was unrelated to the present value of their expected loan losses.

Under the experience method, the maximum reserve was based on average loan losses over recent years. This maximum reserve was determined by first calculating bad debts as a percentage of outstanding loans over the current year and the past five years. Next, this percentage was multiplied by current outstanding loans to equal the maximum reserve to establish a deduction from taxable income. The Treasury could approve an averaging period of less than six years if the risk of loss had substantially increased because of a change in the composition of outstanding loans.

Under the percentage of eligible loans method, the maximum reserve equals a statutorily specified percentage of outstanding eligible loans. For tax years beginning after 1982, this percentage was 0.6 percent. A commercial bank could change between reserve methods (experience and percentage of eligible loans) from year to year. Under prior law, the percentage of eligible loans method would expire after taxable year 1987.

For the charge-off method or either reserve method, the determination of whether a debt was completely or partially worthless was determined by considering all relevant information, including the value of any collateral and the financial condition of the borrower. A debt is not completely worthless if a reasonable expectation exists that it eventually would be repaid in whole or in part.

Advocates of tax neutrality argued that only current losses should be tax deductible. They maintained that the deduction of additions to bad debt reserves was essentially a deduction for discounted future losses. They maintained that no reserve fund actually had to be set up to qualify for the tax break. Thus, they argued that this deduction deferred income from taxation and provided commercial banks with a significant subsidy.

Since the passage of the Tax Reform Act of 1986, different tax treatment for bad debts applies to small banks and large banks. A bank is classified as small if its assets are less than $500 million. The treatment of reserves for bad debts for small banks is the same under the Act as prior law. Large banks must use the specific charge-off method to compute their deduction for bad debts (as must all nonfinancial taxpayers). Also, large banks generally are required to recapture as [taxable] income the remaining balance in their reserves for bad debts over a period of four years. These changes were effective for taxable years beginning after December 31, 1986.

DEDUCTION FOR INTEREST ON TAX EXEMPT OBLIGATIONS

Before the passage of the Tax Reform Act of 1986, commercial banks, thrifts, and certain other financial institutions could deduct 80 percent of the cost of interest on deposits used to purchase tax exempt securities after 1982. For tax exempt securities purchased in 1982 or earlier, 100 percent of the cost of interest on deposits used to purchase these securities was deductible. The calculation for the interest deduction was based on the proportion of a commercial bank's holdings in tax exempt securities. This was called "proportional disallowance." It insured that if a commercial bank owned any tax exempt securities, some of its interest paid would not be allowed as a deduction.

Individuals and nonfinancial corporations could not deduct any of the interest cost of borrowed funds used to purchase tax exempt securities. But the amount disallowed was based on an Internal Revenue Service determination of the purpose of the borrowing; therefore, there was no proportional disallowance. The IRS often had difficulty in linking borrowed funds to the purchase of tax exempt securities by individuals and nonfinancial corporations.

Advocates of the Tax Reform Act of 1986 argued that deduction for interest to carry tax exempt obligations permitted commercial banks and certain other financial institutions to shelter income from taxes and encouraged commercial banks and other financial institutions to make financial investments that were not economically efficient. Consequently, the Tax Reform Act of 1986 disallowed 100 percent of deductions of all financial institutions for interest expenses allocable to tax exempt obligations acquired after August 7, 1986. The 20 percent disallowance would continue to apply to certain bonds issued by small governmental units in aggregate amounts not exceeding $10 million per year. The disallowances are determined proportionally, as under prior law.

SPECIAL RULES FOR NET OPERATING LOSSES

Before the Tax Reform Act of 1986, commercial banks and thrifts were allowed a tax preference for net operating losses (NOLs). For commercial banks and thrifts, NOLs were carried back for 10 prior taxable years and forward to the succeeding five taxable years. Other taxpayers generally could carry NOLs back three years or forward 15 years. Taxpayers prefer to carry back a loss rather than to carry forward a loss because the loss carryback provides an immediate tax refund while a loss carryforward only reduces future tax liabilities.

Advocates of tax neutrality argued that the law unfairly gave commercial banks and thrifts favorable tax treatment for NOLs compared to other taxpayers. Consequently, for NOLs incurred after 1986, the Tax Reform Act of 1986 permitted commercial banks and thrifts to carry back NOLs three taxable years and forward 15 taxable years. A special rule applied to those commercial banks that were required by the Act to use the charge-off method. This special rule allowed these commercial banks a carryback period of 10 years and a carryforward period of five years for NOLs attributable to bad debts in taxable years beginning after December 31, 1986, and before January 1, 1994.

In summary, the Tax Reform Act of 1986 eliminated or curtailed the three major tax preference only available to commercial banks and some other financial institutions. Consequently, U.S. commercial banks pay an effective tax rate on their domestic operations that is approximately equal to the average effective tax rate paid by other corporations.

TAXES AND THE INTERNATIONAL COMPETITIVENESS OF U.S. BANKS

How do foreign and U.S. taxes affect the competitiveness of the U.S. banking industry? As normally used, the term competitiveness refers both to the ability of U.S. firms to compete with foreign imports and to compete with foreign firms for export markets. However, in order to make the scope of the analysis manageable, we have restricted our assessment to the export market. More specifically, the analysis here looks only at the impact of taxes on the ability of U.S. banks to loan funds abroad and to compete for foreign deposits.

The analysis that follows finds that a variety of tax situations confront both foreign bank loans and the export of deposit services, chiefly as a result of U.S. foreign tax credit rules. Foreign bank loans may face either tax neutrality, a tax penalty, or a tax subsidy. Deposit services may be confronted by either a tax penalty or neutrality. Because of these varied results, U.S. tax policy is probably optimal from the point of national economic welfare in some cases but not in others; the same probably holds true from a global welfare perspective. The same analysis suggests that U.S. policy is probably less than perfectly optimal from the perspective of either global or national economic welfare.

TAXES, COMPETITIVENESS, AND ECONOMIC THEORY

In the debate over the impact of U.S. economic policy on competitiveness, public attention has often focused on the level of U.S. taxes compared with the level of taxes paid by foreign competitors. For example, concern is sometimes expressed that U.S. firms may have difficulty competing with foreign companies because foreign firms enter the world market armed with tax and other forms of subsidies. But while it is true that a U.S. firm faced with lightly-taxed foreign competition may have a smaller market share than if its taxes were the same, economic theory also indicates that the level of taxes paid by foreign firms is only of secondary importance. More important is the level of U.S. taxes on trade compared with taxes on production for the domestic market and whether differential U.S. taxes distort either the level of trade or the price of trade goods. In the case of banks, then, the paramount question is whether U.S. tax policy either subsidizes, penalizes, or is neutral towards bank exports compared with the general level of taxation in the United States.[46]

While theory indicates that the level of foreign taxes are only of secondary importance in setting U.S. tax policy, the appendix to this section provides data on foreign tax rates for informational purposes. The data consists of the statutory tax rates that selected foreign countries apply to corporate taxable income in general.

ECONOMIC WELFARE AND INTERNATIONAL CAPITAL FLOWS

A large portion of U.S. bank exports are composed of capital flows: either flows from the United States abroad, as in the case of bank loans; or flows from overseas to the United States, as in the case of exports of deposits. To understand why domestic rather than foreign tax policy is of primary importance in the assessment of these flows, it is helpful to take a brief look at the reasons these flows occur in the first place.[47]

According to economic theory, international capital flows occur because the goal of investors is to maximize profits, and the profitability of investment differs between locations. When a particular unit of capital can earn a higher after-tax return abroad than at home, it leaves its home country. Given their profit-maximizing behavior, investors will distribute their capital among locations so the return on a marginal investment (an incremental investment, or the next investment) is the same at home and abroad. If marginal products were not the same, profits would not be maximized; an investor could always increase total profits by shifting an investment from the low-return location to the high-return country.

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[46] As used here, a tax subsidy exists when the tax burden on either exports or imports is lower than average tax burdens on income from domestic activity. A tax penalty exists when taxes on trade are higher than taxes on domestic income. Tax neutrality exists when taxes on trade are the same as taxes on domestic income.

[47] Similar reasoning to that presented here concludes that domestic rather than foreign taxes are of paramount concern in assessing the impact of taxes on trade in goods rather than capital. See: U.S. Library of Congress. Congressional Research Service. *Tax Policy and U.S. Trade Performance*. Report No 89-635 E, by Gregg A. Esenwein and G. Thomas Woodward. Washington, 1989. 12 p.

As long as the return from investment is the same for society as it is for the investment's owner, the profit-maximizing behavior of investors will result in the allocation of investment that maximizes world economic welfare as well as investor profits; each unit of capital will be employed where it earns both the highest social and private return. Taxes, however, drive a wedge between the private and social returns to capital; owners of capital maximize their after-tax profits, and distribute their investments accordingly. The return to society, however, consists of the entire pre-tax profit from investment, since society (unlike investors) does not lose the use of the portion of return that is collected in taxes.

As a consequence of the divergence between the social and private returns to capital, distorting taxes on international investment can result in a loss of economic welfare. Suppose, for example, a tax is imposed that applies more heavily to foreign than domestic investment. Private investors will respond by shifting assets from foreign locations to domestic ones until the after-tax return on marginal investments are again equal between locations. The tax, however, does not alter the pre-tax, or social returns available in each location, and after the investors' response to the tax, pre-tax returns on marginal investments are no longer the same at home and abroad. Thus, the total social return to investment is reduced by investors' response to the new tax.

This does not mean that all taxes on international investment income damage global economic welfare. As long as a tax applies at the same rate to domestic and foreign investment, the tax will not alter the distribution of investment between foreign and domestic locations. Under such a "neutral" tax regime, global economic welfare will be maximized. On the other hand, if a capital exporting country taxes foreign investment at either a higher or lower rate than domestic investment, global welfare is reduced.

But while global economic welfare is maximized by a neutral tax on foreign investment, the same is not necessarily true of the national welfare of the taxing country. For example, as long as foreign demand for exported capital has any sensitivity (is less than perfectly elastic) to increases in the price of capital, a small tax penalty on the export of capital imposed by the exporting country will reduce global welfare but increase the economic welfare of the taxing country. This is because the revenue gain from imposing the tax – a gain which accrues entirely to the taxing country, but which may be partially borne by foreigners – may outstrip the welfare loss that results from the misallocation of capital. Similarly, as long as the foreign supply of capital has any sensitivity to changes in price, a small tariff or tax penalty on the import of capital will enhance the economic welfare of imposing country. Again, the revenue gain to the taxing country may outweigh the loss of domestic welfare that results from restricting the import of capital.[48]

In contrast to tax penalties, a tax subsidy for capital exports always worsens the economic welfare of the subsidizing country. There are two components to the national welfare loss: one part is a deadweight loss caused by the employment of capital overseas when it could earn a higher pre-tax (social) return at home. In addition, to the extent the benefit of the subsidy is passed on to foreigners, there is a transfer of welfare from the subsidizing country to the importing country.

We return now to the question of foreign taxes. Suppose a foreign country were to subsidize bank loans to a third country, so that U.S. loans to the third country declined. Whether U.S. economic welfare would be improved by reducing U.S. taxes to the foreign level depends on whether the tax reduction would implement a tax subsidy or would simply remove an excessively high tax penalty *vis a vis* investment in the United States. If the reduction is a subsidy, U.S. economic welfare would be damaged by the counter-measure. If the reduction moves U.S. taxes towards neutrality, it may or may not improve U.S. welfare, depending on whether market conditions establish neutrality or a tax penalty as the optimal policy for U.S. economic welfare. In any event, it is clear that foreign taxes are not relevant in determining optimal U.S. tax policy towards international investment. What matters is U.S. treatment of foreign investment compared to taxation of investment in the United States.

THE CASE OF A BANK LOAN

To add concreteness to theory, it is useful to look at how it applies to the particular case of a bank loan. Suppose, to begin, that the United States were to tax interest on foreign loans at the same rate as it taxes the return to domestic investment in general. In such a situation, taxes would not alter the extent to which the United States exports loans; and U.S. tax policy would maximize global economic welfare. The economic welfare of the United States, however, might not be maximized, since a tax penalty for exporting capital may be more beneficial.

Suppose, however, the United States were to introduce a tax subsidy for loaning abroad by taxing interest from foreign loans at a lower rate than income from domestic business. Banks would normally respond by reducing the interest rate they charge to foreigners; foreigners would respond by borrowing more funds from U.S. banks. One result is thus immediately apparent; the United States would be exporting loans beyond the point that maximizes the social return to the exported capital. There would thus be a welfare loss from a misallocation of capital.

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[48] For a more detailed discussion, see: Stern, Robert M. *The Balance of Payments*. Chicago, Ill. Aldine Publishing Co., 1973. p. 272-5. For treatment that focuses exclusively on the import of capital, see: Corden, W.M. *Trade Policy and Economic Welfare*. Oxford. Clarendon Press, 1974. p. 330-347.

The logic of optimal taxation and capital flows parallels the theory of taxes and trade policy, including the concepts of an optimal tariff and optimal export tax. See: Lindert, Peter H. and Charles P. Kindleberger. *International Economics*. 7th Ed. Homewood, Ill. Irwin, 1982. p. 500-506.

But the U.S. Treasury would also realize a loss in tax collections. Part of this loss would benefit the owners of U.S. banks: a transfer of income within the United States, but not a net loss of national economic welfare. Part of the revenue loss, however, would be passed on to foreign borrowers in the form of reduced interest rates: a transfer of economic welfare from the United States abroad. Thus, in the particular case of banks, a subsidy would damage national economic welfare.

U.S. TAXATION OF FOREIGN BANK LOANS AND DEPOSITS

The United States taxes the income of its corporations on a worldwide basis, applying the same statutory tax rates and rules for deductibility of costs to foreign as domestic income. At first glance, then, it would seem that the United States tax system is neutral towards international capital flows. But foreign countries often impose their own taxes on the foreign-source income of U.S. banks and other corporations, and to provide relief from double-taxation, the United States allows its taxpayers to credit foreign taxes against U.S. taxes. And the set of rules surrounding the U.S. foreign tax credit results in an array of different tax situations. In some of these situations, U.S. tax policy is indeed neutral towards international capital flows. In other cases, however, the United States either subsidizes or penalizes income from international capital.

We look first at how U.S. tax policy applies to foreign loans of U.S. banks, and then turn to the treatment of foreign deposits.

Taxation of Foreign Loans

If foreign taxes could be credited without limit, the U.S. policy of worldwide taxation and granting of foreign tax credits would produce equal taxation of foreign and domestic income and would pose neither an incentive nor a disincentive to towards bank loans and other types of foreign investment. Where foreign taxes are lower than U.S. taxes, after-credit U.S. taxes would make up the difference between the foreign and U.S. tax rates. To the extent foreign taxes exceed U.S. taxes, they could be used to offset U.S. taxes on domestic income, thereby bringing the effective, after-credit tax rate on foreign-source income down to the U.S. tax rate.

But a limitation on the foreign tax credit does exist: in order to protect the U.S. tax base, the U.S. tax code stipulates that foreign taxes can only be used to offset the portion of a taxpayer's U.S. tax liability that is assessed against foreign rather than domestic income. The rules that implement this limitation can result in tax subsidies, tax penalties, or tax neutrality, depending on the situation of the capital-exporting firm and the level of taxation imposed by the foreign country that is host to the investment.[49]

The tax code implements its foreign tax credit limitation with the following formula:

$$\frac{\text{Foreign Income}}{\text{U.S. Income + Foreign Income}} \times \begin{array}{c}\text{Total}\\ \text{Pre-Credit}\\ \text{U.S.}\\ \text{Taxes}\end{array} = \begin{array}{c}\text{Maximum}\\ \text{Creditable}\\ \text{Foreign}\\ \text{Taxes}\end{array}$$

If foreign taxes exceed this limitation in a particular year, a firm may not pay any U.S. taxes on its foreign-source income for that year but will also have so-called "excess credits" (foreign taxes that cannot be credited) to the extent foreign taxes exceed U.S. taxes. On the other hand, if a firm's foreign taxes are lower than U.S. taxes on foreign income in a particular year, then the firm will owe some residual amount of U.S. taxes on its foreign-source income, and will have a so-called "credit deficit."

Whether the foreign tax credit limitation poses a tax penalty, a tax subsidy, or tax neutrality towards a marginal foreign investment depends on whether the investing firm's existing ("infra-marginal," in the jargon of economics) investments have placed it in an excess or deficit credit position, and on whether the income produced by the marginal investment is subject to foreign tax rates that are higher or lower than those in the United States.

Suppose, for example, a bank makes a new loan to a country that taxes interest payments to foreigners at relatively low rates. If the bank has no other foreign-source income or is in a deficit position with respect to foreign tax credits, foreign taxes will offset some but not all of the U.S. taxes due on income from the loan, and the combined effective tax rate on the loan will be equal to the general U.S. tax rate. If, however, the bank has existing foreign-source income that has placed it in an excess credit position, the bank can generally use excess credits to offset the residual U.S. tax liability on the prospective loan. Thus, when a firm has excess credits, the effective tax rate on a loan to a low-tax country is equal to the relatively low foreign tax rate, and U.S. tax policy provides a subsidy for the loan.

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[49] When the combined U.S. and foreign tax rate exceeds the U.S. domestic tax rate, a U.S.-imposed tax penalty or a foreign-imposed tariff could equally be said to apply. However, international convention dictates that the country where income has its source has the primary jurisdiction to tax that income; it is thus the responsibility of an exporter's home country to provide relief from double taxation, either in the form of foreign tax credits or by other means. In view of this convention, the analysis here assumes that foreign tax rates are invariant with respect to U.S. tax rates, and a differential tax burden on foreign-source income is the result of actions by the exporting country. Thus, relatively low or high taxes on foreign-source income are a tax subsidy or a tax penalty rather than an import subsidy or tariff.

There are four basic tax situations that can confront a foreign loan or other type of foreign investment; these are summarized below, in figure 1, along with the tax consequences of each situation. In situation 1, a firm with excess credits loans to a low-tax country. As described above, the United States provides a tax subsidy in this particular case. In situation 2, an excess credit firm loans to a high-tax country. Here, excess credits generated by the new loan cannot be used to offset U.S. taxes due elsewhere because foreign tax credits have already offset all existing U.S. taxes. The effective tax rate on the new loan is thus equal to the relatively high foreign tax rate. In this case, U.S. policy establishes a tax penalty towards foreign investment.

In situations 3 and 4, neutrality exists towards foreign loans. In situation 3, a firm with a deficit of credits loans to a low-tax country. Unlike situation 1, the lending firm has no excess credits to protect its new lightly-taxed foreign loan from U.S. taxes. Thus, the effective tax rate is the U.S. tax rate. In situation 4, the foreign tax rate exceeds the U.S. tax rate and the new foreign investment generates new excess credits. However, because the firm is in a deficit credit position with respect to its existing income, the new excess credits can be used to offset U.S. taxes on existing income, and the effective tax rate on the new loan is again equal to the U.S. tax rate.

From the discussion in the preceding section, it is clear from figure 1 that current U.S. tax policy towards bank loans maximizes neither national nor global economic welfare. From a global perspective, neutrality is the optimal tax policy. Thus, U.S. policy falls short of its optimal level to the extent that marginal loans confront situations 1 or 2 and face either a tax subsidy or penalty.

FIGURE 1. Tax Situations for Foreign Bank Loans

Situation 1 Excess Credits/ Low Foreign Taxes Effective Tax Rate Equals Foreign Tax Rate Tax Subsidy	Situation 2 Excess Credits/ High Foreign Taxes Effective Tax Rate Equals Foreign Tax Rate Tax Penalty
Situation 3 Deficit of Credits/ Low Foreign Taxes Effective Tax Rate Equals US Tax Rate Tax Neutrality	Situation 4 Deficit of Credits/ High Foreign Taxes Effective Tax Rate Equals US Tax Rate Tax Neutrality

From a national perspective, the subsidization of loans in situation 1 clearly reduces domestic welfare. Further, it is reasonable to assume that foreign demand for U.S. loans is less than perfectly elastic. Thus, a small tax penalty is the optimal U.S. policy, and the neutral treatment of lending in situations 3 and 4 also reduces U.S. economic welfare. Note, however, that whether the tax penalty in situation 2 is optimal cannot be determined without additional data; the tax penalty may be either higher or lower than that required to maximize national welfare. Also, this assessment ignores the possibility that a U.S. export tax may trigger countervailing foreign measures.

A more general assessment of the impact of U.S. tax policy is difficult because of data limitations. For example, information on the number and size of U.S. banks in an excess credit position would help identify the relative importance of the situations where U.S. policy is and is not welfare-maximizing. Unfortunately, such figures are not available.

Circumstantial evidence, however, suggests that many bank loans occur in situation 2, where a tax penalty exists. First, in cases where foreign countries tax the interest U.S. banks earn on their foreign loans, the taxes that apply are typically withholding taxes that are levied on a "gross" basis; that is, costs are not deductible in calculating income subject to tax. In contrast, the U.S. permits banks to deduct costs such as interest payments, bad debts, and administrative costs in calculating taxable income. Thus, foreign withholding taxes that are applied at relatively low statutory rates can nonetheless be "high tax" loans for foreign tax credit purposes, and can easily generate excess credits.

Second, rules implemented by the Tax Reform Act of 1986 (Public Law 99-514) stipulate that taxpayers must calculate a separate foreign tax credit limitation for interest income that is subject to high foreign withholding taxes.[50] Thus, excess credits generated by some foreign withholding taxes cannot be used to offset U.S. taxes on other types of income. This change increases the likelihood that a U.S. bank will be in an excess credit position with respect to foreign loans.

Given the ambiguous nature of the tax penalty in situation 2 from a national-welfare perspective, the circumstantial evidence sheds no additional light on U.S. national welfare and loan taxation. In the case of global welfare, however, the evidence does suggest that the cases in which U.S. tax policy is not neutral towards foreign lending are relatively important and that the general thrust of U.S. policy is not optimal from a global perspective.

Taxation of Foreigners' Deposits

In assessing the impact of U.S. taxes on the level of foreign deposits in U.S. banks, the foreign tax credit is again the protagonist – at least from the perspective of U.S. suppliers of deposit services.[51] In this case, however, the focus is on the credit's rules governing the treatment of interest costs U.S. banks pay to foreign depositors. As we shall see, if a taxpayer is in an excess credit position, the foreign tax credit limitation may partly nullify any benefit from the deduction of interest, and a tax penalty exists with respect to providing deposit services to foreigners. On the other hand, if a taxpayer is in a deficit foreign tax credit position, the full benefit of the interest deduction can be realized, and tax neutrality results.

The tax penalty can occur because of the foreign tax credit rules that determine the geographic source of interest costs (so-called "sourcing rules"). To see how the penalty works, we return to the formula for the foreign tax credit limitation, presented above on page 47. Suppose, first, that a taxpayer is in an excess credit position; for this particular firm, the limitation on the right side of the formula is lower than the total amount of foreign taxes the taxpayer has paid. Any additional reduction in the limitation will reduce creditable foreign taxes and increase the taxpayer's U.S. and total tax burden.

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[50] Specifically, the separate limitation applies to interest that is subject to a withholding tax of 5 percent or more.

[51] As noted above, in footnote 48, convention places the primary responsibility determining the total tax burden on international capital in the hands of the capital exporting country. We thus confine our assessment to U.S. taxation of the banks that provide deposit services to foreigners and do not look at U.S. taxation of the depositors themselves.

Next, suppose the taxpayer accepts a foreign bank deposit and begins to pay interest. Initially, in calculating its pre-credit U.S. tax liability, the taxpayer can deduct the interest as a business expense, achieving pre-credit U.S. tax savings amounting to the marginal tax rate times the amount of the deduction. But now the U.S. source rules for interest expense become critical. If U.S. tax policy were to characterize the interest expense as having a foreign source, the expense would reduce the fraction on the left of the credit limitation equation and reduce creditable foreign taxes. In fact, if the entire amount of interest expense is "sourced" abroad, the reduction in creditable foreign taxes exactly offsets the savings in pre-credit taxes resulting from the deduction of the interest expense. In effect, the deduction would be disallowed. And because business costs associated with domestic activities are generally deductible in full, sourcing of costs abroad would constitute a tax penalty.

U.S. tax rules governing the sourcing of interest expense are not quite as stark as this. The Internal Revenue Code requires interest expense to be split between foreign and domestic sources based on the fraction of the taxpayer's assets (including loans) that are located in the United States and those that are located abroad. For example, if half of a firm's assets are overseas, half of interest expense would be sourced abroad. Accordingly, only part of the deduction for interest expense is lost, and the tax penalty confronting excess-credit firms that import foreign deposits is mitigated.

For banks with a deficit of credits, U.S. tax policy is neutral towards providing deposit services. When in a deficit position, a taxpayer has some residual U.S. tax liability, and even if part of interest expense is source abroad, the deduction still provides tax savings in the form of a reduction of taxes on foreign-source income.

As with policy towards bank loans, U.S. treatment of foreign deposits does not maximize global welfare; the tax penalty posed to firms with excess credits reduces global welfare. Also, it is doubtful that U.S. policy maximizes national welfare, since a welfare-maximizing policy probably requires a small tax penalty on imports of capital, and U.S. tax policy is neutral towards some deposits.

As with bank loans, the tax penalty on some deposits does not necessarily maximize United States welfare. As with loans, the penalty that exists may be larger or smaller than that which is optimal. Also, we should note that the same foreign tax credit mechanism that creates the penalty on foreign deposits also confronts domestic deposits of excess-credit banks. As with foreign deposits, part of the interest expense associated with domestic deposits is sourced abroad as long as a firm has foreign assets. Thus, the same policy that imposes a tax penalty on the export of deposit services also results in a tax penalty and welfare loss not directly related to international trade. This reduces the chance that U.S. policy towards sourcing of interest is optimal.

SUMMARY OF TAX CONSIDERATIONS

Economic theory indicates that in assessing the impact of taxes on U.S. competitiveness, the primary focus should be U.S. tax treatment of U.S. exports and imports rather than on the level of foreign taxes. Theory also suggests that a tax that is neutral towards exports and imports of banking services as well as other exports and imports maximizes worldwide welfare. In contrast, a small tariff on imports or a small tax penalty on exports is probably optimal from the point of view of United States economic welfare.

The results of U.S. taxation of bank loans depend heavily on the Internal Revenue Code's foreign tax credit rules; the rules produce a variety of tax results for foreign loans. In some situations, U.S. tax policy is neutral towards foreign loans while in other cases U.S. policy either subsidizes or penalizes foreign loans. Thus, whether U.S. tax policy is optimal from either a global or national perspective depends on the situation. It is also clear, however, that U.S. treatment of bank loans is not perfectly optimal from either a national or global perspective.

U.S. treatment of the provision of deposit services to foreigners also depends on the foreign tax credit, with results that are similarly mixed. For some banks, the foreign tax credit rules result in a tax penalty for the provision of deposit services; in other situations U.S. taxes are neutral. Again, global and national welfare results are mixed and the U.S. policy is less than perfectly optimal from either perspective.

APPENDIX C. STATUTORY CORPORATE TAX RATES IN SELECTED FOREIGN COUNTRIES

A comprehensive search of foreign tax systems for special provisions that apply to the banking industry is beyond the scope of this study. The information that follows is thus limited to the statutory tax rates that are applied by foreign countries to corporate taxable income in general. The information is based on recent editions of several reference publications on international taxation. Nonetheless, the data should be used with caution, since tax laws in foreign countries (like those of the United States) have a tendency to change frequently.

For Canada, Italy, and Japan, table 18 (below) includes subnational income taxes along with national-level taxes. Based on information in our reference sources, subnational taxes appeared to be particularly significant in these three cases. This does not necessarily mean, however, that no subnational taxes apply in the case of the other countries. U.S. States, for example, typically levy their own corporate income taxes. Thus, the total tax rates where subnational taxes are not included are probably understated.

TABLE 18. Statutory Corporate Tax Rates in Countries Belonging to the Group of Ten

Country	Tax Rate
Belgium	43%
Canada	43.5a/
France	42 (distributed profits) 39 (retained profits)
Italy	52.2b/
Japan	51.03c/
Netherlands	35
Sweden	52
United Kingdom	35
United States	34
West Germany	36 (distributed profits) 50 (retained profits)

a/Consists of a 28 percent Federal rate (38 percent minus a 10 percent abatement granted when provincial taxes are paid) plus a Provincial rate of 15.5 percent. Provincial rates vary, but a 15.5 percent rate is characterized as "typical" in: Price Waterhouse. *Corporate Taxes: a Worldwide Summary*. New York, 1989. p. 64. Note also that a slightly reduced rate applies to manufacturing income.

b/Consists of a 36 percent Federal rate and a 16.2 percent local tax rate.

c/Consists of a national tax, two subnational taxes (prefectural and municipal) and an enterprise tax. For the applicable rates of each, see: Gomi, Yuji. *Guide to Japanese Taxes, 1989-90*. Tokyo, Zaikei Shoho Sha. 1989. p. 16.

Sources (unless otherwise noted): Price Waterhouse. *Corporate Taxes: a Worldwide Summary*. New York, 1989; Diamond, Walter H., edit. *Foreign Tax and Trade Briefs*. New York, Matthew Bender. 1989.

IMPLICATIONS FOR CONGRESS

BANK CAPITAL

The Congress may have occasion to reconsider allowing U.S. bank capital requirements to be determined in international frameworks such as the Basle Accord, because of the clear differences between the U.S. banking system and those of U.S. banks' major competitors.[52] The Congress, which began setting guidelines for bank capital in 1983 for the first time, but since then has deferred to the bank regulators (i.e., Federal Reserve Board and the Comptroller of the Currency), may take a second look at the expectations of the bank regulators that higher capital or prudential requirements are best for U.S. banks. Higher capital requirements, though valuable for soundness and liquidity, may impair U.S. banks' ability to compete not only internationally, but also domestically. A factor in such reconsideration is that the European and Japanese banking systems have much in common, while the United States system is quite different. For example, of the nearly 13,000 banks in the United States, the ten top international banks account for almost 80 percent of the U.S. banks' international assets but less than 20 percent of the total domestic assets. U.S. regional banks hold most of the domestic assets. In almost all the European countries and Japan, however, the banks that hold the majority of the international assets are also the banks that hold most of the domestic assets. Regulating and conducting monetary policy with homogeneous capital requirements is much easier for these competitors than in the United States where there are far greater distinctions between international banks and domestic banks.

BANK TAXATION

Few banking experts blame the recent poor performance of U.S. banks on the efforts of the 99th Congress to equalize the effective tax rate between the banking industry and other industries.[53] The implication of the analysis done here is that, generally speaking, tax subsidies for banks in hopes of enhancing their competitiveness abroad are likely to reduce the welfare of the United States as a whole. However, it might be possible to fine tune the tax provisions concerning certain types of deposits and loans to enhance U.S. bank competitiveness without welfare loss, but the required data on foreign tax policies and U.S. banking activities abroad to do the job correctly are unavailable. Statistics on row averages of tax rates paid by banks in various countries may not be helpful in this regard; although they do suggest that U.S. banks are taxed less in the aggregate than are many of their international competitors.[54]

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[52] U.S. Library of Congress. Congressional Research Service. *The European Central Banking System and the 1992 Monetary Union*. Report no. 90-42E, by Walter W. Eubanks. Washington 1990. 17 p.; and, *Merchant Banking: Opportunities or Problems for U.S. Banks?* Report no. 87-351E, by Walter Eubanks and William Jackson. Washington. 1989. 14 p.

[53] U.S. Library of Congress. Congressional Research Service. *Bank Soundness in Light of The Tax Reform Act of 1986 and Possible Glass-Steagall Act Repeal*, by Walter Eubanks. Report no. 88-118E. Washington. 1988. p. 3.

THE REGULATORY FRAMEWORK

Congress has had a profound impact on the health of banking institutions through legislation covering the banking industry to ensure soundness. The three main routes are capital requirements, deposit insurance, and selective regulation of activities in which banking institutions may engage. For the most part, the Congress has deferred on capital requirements to the regulators, but kept deposit insurance in its jurisdiction. While deposit insurance may be a key factor in determining the degree of confidence in the banking system, the cost of the insurance does not directly affect the performance of banking institutions as much as capital requirements, and the areas and degree to which banks may engage in other commercial activities. Even so, reform of the deposit insurance funds may become a top priority for the Congress mainly because of the poor condition of these funds following the record number of bank and thrift institution failures.[55] Also, it is important to note that deposit insurance, which was adopted by many foreign countries following the U.S. model, may tend to undermine other important factors that ensure bank soundness.[56] This is due to what economists call the moral hazard problem, where the existence of government insurance tends to foster risky behavior. Even though sentiment may be to reduce deposit insurance or raise premiums, any further reform of the deposit insurance system will have less of an impact on U.S. banks' competitiveness than the selection of capital requirements and the successful performance of U.S. banks in nontraditional activities.

In short, this analysis points to four primary concerns on the ability of U.S. banks to compete in the global economy:

- The twin deficits — trade and Federal budget — have contributed to the poor performance of U.S. banks in terms of their holdings of international and domestic assets, by reducing both national savings and U.S.-owned bank deposits.

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[54] American Bankers Association. *International Banking Competitiveness-Why It Matters*. Washington, 1990. p. 84.

[55] U.S. Library of Congress. Congressional Research Service. *Banks and Thrifts: Restructuring and Solvency 1990*. Issue Brief IB90002, by Jean Wells. Washington. (updated regularly). p. 9.

[56] U.S. Library of Congress. Congressional Research Service. *Deposit Guarantees in Other Countries*. Report no. 89-637E, by G. Thomas Woodward. Washington. 1989. 17 p.

- Agreeing to internationally-determined capital requirements for U.S. banks might not necessarily be beneficial to United States in the long run because of the marked differences between the U.S. banking system and the systems of Europe and Japan.
- While U.S. banks are paying a higher effective tax rate, than in early 80s, about equal to other industries since the 1986 Tax Reform Act, they remain among the most profitable of industrial countries' banks. These factors suggest that increased tax subsidies for banks might result in a welfare loss for U.S. taxpayers.
- Congress is expected to take up bank insurance reform in the next session once the *Financial Institution's Reform, Recovery, and Enforcement Act* (FIRREA) mandated studies are completed. However, deposit insurance has less direct impact on U.S. banks' competitive performance in the global economy than capital requirements and the range of activities in which banks may engage.

we/mls

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

August 10, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

I am responding to your letter of July 13, 1990 in which you asked a number of follow-up questions to my testimony before the Senate Committee on Banking, Housing and Urban Affairs on July 12, 1990.

The answers to your questions are presented in the enclosure. Please let us know if we may be of further help with regard to these matters.

Sincerely,

Chairman Greenspan subsequently submitted the following in response to written questions from Chairman Donald W. Riegle, Jr., in connection with the hearing held on July 12, 1990.

Q.1. In your testimony, at page 10, you observe that critics of imposing higher capital requirements on U.S. banks could argue that international competitors that only adhere to the minimum capital requirements in the Basle Accord would be given a competitive advantage. But you reply that banks with higher capital are better positioned to be successful in the international arena.

If this is so, have competitive market forces driven banks to raise capital above minimum levels?

A.1. The evidence is clear that the customers of wholesale banks operating domestically and internationally want to deal only with financially sound banks. Perceptions of financial strength are based on more than one factor but chief among them are: (1) a strong enough capital position to operate broadly and deeply across financial markets and to provide flexible and continuous customer support over the long run; (2) profitability to sustain that capital position; (3) technological and market expertise; and (4) customer perception of government support in times of duress. In some cases, the last has been particularly important in the past, although the Basle Capital Accord and competitive pressures have eroded the weight placed on such support by international customers.

Very few internationally competitive banks appear to have a strategy to operate at Basle Accord minimum capital levels. Indeed, as I noted in my testimony, many successful U.S. and foreign institutions today substantially exceed such standards. I interpret the evidence as indicating that, almost without exception, the most successful banks operating domestically and internationally have capital significantly above minimum levels, and that this result is most certainly a competitive reaction to market forces.

Q.2. Since the cost of capital for U.S. firms is higher than the cost of capital for our international competitors, aren't U.S. firms already at a competitive disadvantage without imposing higher capital requirements?

A.2. The concept of the cost of capital is reasonably well-understood in economic theory, but quantitative comparisons of the cost of capital facing firms in various countries are difficult because of the complex set of factors that enter into the calculations. A number of studies have attempted cross-national comparisons of the costs of capital for various projects but have not focused on banks specifically. Nonetheless, a frequent conclusion has been that U.S. firms faced higher capital costs than some foreign firms in the past. There is some evidence that such differences in capital costs, if any, are less pronounced now.

In any case, raising new capital will be neither easy nor cheap for U.S. banks. In the short run, higher capital requirements for U.S. banks are likely to place foreign banks in somewhat better competitive positions. This would be true even if, as might be the case, the cost of capital to U.S. banks is no higher than it is for every other bank.

However, it would be short-sighted to overlook the urgent need to induce market-sensitive behavior by banks. Over the long run, our banks, to compete successfully, must be prepared to meet new opportunities and changing circumstances. Well-capitalized banks are best positioned to be successful in broadening the scope of their activities and in exploiting profit opportunities. Such organizations are perceived in the market as the most attractive counterparties for a large range of financial transactions.

Q.3. Raising capital should help protect the deposit insurance system, but as we learned from RAP accounting in the thrift industry, it is easy to raise capital by simply lowering accounting standards.

A number of witnesses had advocated the use of market value accounting to measure bank capital. Indeed, the Fed's early intervention proposal would seem to mandate a form of market value accounting.

Is market value accounting a good idea? If not, why not?

A.3. The problems in our financial system over the last several years have focused attention on the considerable differences that often have been found to exist between accounting and economic measures of the earnings and net worth of financial institutions. Market value accounting has been proposed by some as a way to narrow divergences between accounting and economic measures of income, assets, liabilities, and equity capital positions. This suggestion is primarily based on the view that the market values of assets and liabilities are more reflective of their true economic values than are the historical costs amounts generally reported in financial statements under generally accepted accounting principles (GAAP). Therefore, it is argued that the use of market value accounting might lead to more effective regulation and supervision of financial institutions and to the closure of problem institutions long before they would become insolvent on the basis of financial statements prepared under GAAP.

While this proposition is of theoretical interest, a number of concerns have been expressed regarding market value accounting that should be considered. First, market value accounting could result in more volatility in the reported financial condition and earnings of financial institutions, thus possibly making judgments by the regulatory agencies, as well as by investors and depositors, much more difficult. Second, market values do not exist for a large percentage of a financial institution's assets and liabilities and standards have not yet been developed for the estimation of reliable market values for these items. Third, financial statements prepared solely on a market value accounting basis would generally meet the needs of a very limited group of users -- those interested in the liquidation value of institutions -- while perhaps not being relevant to many other users. Fourth, the overall cost and reporting burden associated with market value accounting could be considerable, including the cost of verifying market value quotations and estimates during audits and supervisory examinations. Furthermore, because market value accounting can lead to a sudden change in asset values, concerns have been expressed that market value accounting might result in potentially adverse reactions by financial institutions, depositors, and investors affecting credit availability, financial stability, or the competitiveness of U.S. banking and thrift institutions.

In my view, these concerns should be thoroughly studied before dramatic moves toward market value accounting are made. The federal banking agencies are reviewing the use of market values in connection with the federal deposit insurance study mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). At the same time, the Financial Accounting Standards Board (FASB) is studying the need for greater use of market values in GAAP as part of a project to develop new comprehensive standards for all financial instruments. These studies should provide additional information regarding the appropriateness of market value accounting for purposes of bank regulation and financial reporting.

My testimony included a proposal for prompt corrective action. A key part of this proposal is the conduct of on-site examinations -- focusing on the quality of asset portfolios and off-balance sheet commitments -- at least annually, where it is not already in practice. This rigorous review would help ensure that the loan loss reserves are consistent with the quality of the portfolio. When they are not, the examiner would insist that additional reserves be created with an associated reduction in the earnings and equity capital of the bank. This would lead to a more timely review of the adequacy of loan loss reserves and in a more accurate measurement of capital positions. When the resultant capital position of the bank is not adequate and credible capital raising commitments are not met, the regulatory agency would promptly require such responses as lowered dividends, slower asset growth, divestiture of affiliates, and other corrective measures while an institution's capital position is still positive. Such a policy would not only deter banks from riskier lending practices, it would also minimize the ultimate resolution costs.

However, this is not a proposal for market value accounting. While the adjustment of recorded asset values for inherent credit losses can be accomplished through market value accounting, it can also be accomplished under existing GAAP. Timely, thorough on-site examinations focusing on asset quality, together with rigorous application of GAAP, should result in loan loss reserves that more accurately reflect the estimated credit losses inherent in loan portfolios and in more accurate reported capital positions. This would narrow divergences between accounting condition and economic measures of depository institutions' financial condition and performance, while avoiding the potential problems associated with market value accounting.

Q.4. At an earlier hearing on financial modernization, the investment company institute recommended that Congress create so-called "narrow banks" that limit the use of insured deposits to investments in safe, liquid securities. This approach is designed to substantially reduce the risk of loss to the Federal Deposit Insurance System and address concerns relating to the competitive inequality created by deposit insurance.

Your testimony suggests that narrow banks are not a good idea. Why?

A.4. If we were starting from scratch, the narrow bank concept has two attractive characteristics. The public's payments accounts and insured liquid assets would, in turn, be backed by a portfolio of liquid, high quality, short-term assets, reducing the subsidy from deposit insurance to virtually zero. Second, the narrow bank implies that customers of banks would more directly bear the cost of deposit services. Since the narrow banks' profits would reflect only a narrow spread between very low-risk assets and virtually riskless liabilities, it is likely that there would be explicit fees on checking accounts to cover the banks' total cost of payment services; the customers' opportunity cost of holding bank deposits also would presumably rise as the average portfolio yield of banks declined relative to those of today.

However, if we imposed this structure on the existing banking system, a substantial institutional change would be required, dramatically modifying the way the public obtains its payment services. The profitability of narrow banking would be very limited, since its risk would be virtually non-existent, and many small banks would thus likely find it impossible to continue to operate on the resultant very narrow interest rate margins or user fees. The public cost of checking services would rise sharply, presumably reflecting the full cost of the services since banks could no longer absorb as much of that cost as a way to fund higher yielding assets.

In addition, most of the credit demands now met at banks for households, businesses, states, and local governments would not result in assets that could be held at narrow banks. A substantial part of such credit demands would presumably be met by uninsured bank affiliates, financing their holdings of claims on these entities with the owners' capital and short- and long-term funding from the public. It is likely that only larger banking organizations would be able to enter this business, concentrating intermediated business and consumer credit flows. While it is true that such affiliates--with no safety net--would likely be more cautious lenders than banks, credit and maturity mismatch risks would not be eliminated. Difficulties could then, as I noted in my testimony, result in creditor runs that could be transferred to rival financing affiliates, similar to the process in earlier years among uninsured banks. That is why I said in my testimony that "...we might end up with the same set of challenges we face today, refocused on a different set of institutions."

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

September 5, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am responding to your letter of July 23 in which you enclosed a number of follow-up questions to my testimony before the Senate Committee on Banking, Housing, and Urban Affairs on July 12, 1990.

The answers to these questions from Senators D'Amato and Bryan are presented in the enclosure. Please let us know if we can be of further assistance.

Sincerely,

Enclosure

Questions from Senator D'Amato

Q.1. The new powers that commercial banking organizations seek--be they securities or other financial services activities--are services that currently are being performed by the private sector without government backing and without exposure to the federal deposit insurance funds or the American taxpayer. Would you agree that it should be a condition of such expanded powers for a commercial banking organization that there be absolute assurance that those activities will not involve the participation of the federally insured banks within such organization?

A.1. It is important to underline, as I noted in my July 12 testimony, that these new powers should be authorized only for well-capitalized banking organizations that can absorb the risks of new activities without drawing on the safety net. While the Board is in the process of reevaluating so-called "thick" firewalls, there still would be considerable risk insulation if the financial relations between the bank and all of its affiliates were only limited by Sections 23A and B of the Federal Reserve Act. Not only do those provisions quantitatively limit bank loans (unless collateralized by U.S. government securities) to each affiliate and to all affiliates--based on the banks' capital--but such loans must be fully collateralized, and loans and asset transfers must be under the same terms and conditions as would be provided by the bank to nonaffiliated borrowers or counterparties.

With higher capital required for banks and with SEC supervision of securities affiliates, the Board would support well-capitalized insured banks having financial relationship with securities affiliates, subject to at least the restrictions of Sections 23A and B. It makes little sense to permit banking organizations to own securities affiliates if their ability to draw on the synergies of affiliation is eliminated.

Q.2. Commercial banking organizations object to restrictions on interaction--so-called "firewalls"--between affiliates engaged in securities and other speculative nonbanking activities, on the one hand, and their federally insured banks, on the other. Why should commercial banking organizations be permitted use their own federally insured banks to subsidize and support the kind of entrepreneurial and speculative activities that are currently being carried on by securities firms and others without such direct risk exposure to the federal deposit insurance system?

A.2. As the answer to question 1 suggests, the Board believes that at least firewalls like those required in the Federal Reserve Act--Sections 23A and B--should be applied to limit the transference of the safety net from banks to their nonbank affiliates, and that banks with securities affiliates should have high capital to offset further safety net subsidies. Banking organizations should be permitted to engage in securities activities under such conditions because market innovation, technological change, and globilization of financial markets have already made the securities and banking business virtually indistinguishable from each other, both here and abroad. Recognizing that reality will also provide an improved and more convenient level of service to businesses and investors, as well as a more viable banking system.

I want to note that the Board does not support "speculative" nonbanking activities, nor does it believe that securities firms should be so categorized.

Q.3. If the argument for permitting a commercial banking organization's securities or other nonbanking affiliates to interact with its federally insured banks is that international competitiveness requires the ability to provide banking services combined with other financial services, why not, as some have suggested, permit a commercial banking organization to form an uninsured "wholesale" credit institution or bank for such purposes, and leave its federally insured banks, Uncle Sam and the taxpayer out of the picture altogether?

A.3. There are attractions to the creation of an uninsured "wholesale" bank subsidiary of a bank holding company that could lend to certain nonbank affiliates, while the insured bank would not be permitted to do so. Chief among these is the safety net insulation. However, this approach would create inefficiencies and costs which, on balance, the Board believes could be avoided by permitting the insured bank to make such loans under constraints similar to Sections 23A and B, and requiring that insured bank with securities and similar affiliates must have high capital ratios. This approach, too, would minimize safety net transference. We are also concerned about the terms and conditions under which an uninsured bank should have access to the discount window and the payments system.

Q.4. There appears to be an emerging consensus in favor of functional regulation of financial services. In order to implement such functional regulation, isn't it essential to move securities and other nonbanking activities out of federally insured banks into separately capitalized, independent subsidiaries of bank holding companies?

A.4. Functional regulation would be easier if the activities being regulated by the nonbank regulator were in separate subsidiaries, although, in principle, such regulation could also be accomplished in bank departments. It is not clear that there is any benefit to requiring that activities which have been successfully and safely conducted in a bank for long periods of time--e.g., dealing and underwriting U.S. government and state and local government obligations and certain revenue securities or foreign exchange trading--should be shifted to special holding company subsidiaries just because nonbank firms also engage in that activity.

Q.5. If we keep the federally insured banks and thrifts within a commercial banking organization out of the speculative and risky activities involved in "wholesale" worldwide securities, securities-related and banking activities, will not the risk to the American taxpayer through the federal deposit insurance fund be reduced and self-discipline and market discipline increased for the other parts of the business, which would not be covered by the protective net of the FDIC?

A.5. There is a risk that the activities of a bank affiliate in a bank holding company may cause difficulties for the bank, either because of unusual losses on credit extensions by the bank to those affiliates or because problems in the affiliate may cause creditors of the bank to question the ability of the bank to meet its obligations. However, higher capital limits, such as the requirement for collateral of, and quantitative limits on, loans to affiliates (Section 23A of the Federal Reserve Act) and the requirement for arms-length financial transactions (Section 23B) all either greatly reduce the potential for loss or increase the ability of the bank to absorb such loss. Access to the discount window provides solvent banks with temporary liquidity access. Finally, after these safeguards, any resultant losses to the safety net will be absorbed by the insurance fund, further reducing the potential for taxpayer cost absorption.

Questions from Senator Bryan

Q.1. Apart from your prepared statement, you indicated that some firewalls might still be desirable even with stronger capital requirements and more adequate supervision. Specifically, what firewalls were you referring to? Under what conditions would they be imposed or removed? How would they differ from requirements the Federal Reserve currently imposes on financial institutions petitioning the Board to engage in new financial activities?

A.1. As I stated in my testimony, I believe that the reform of bank capital and supervisory policies is the most promising approach to reform of the deposit insurance system. However even if the changes recommended in my testimony were adopted, we would intend to continue to retain some limitations on a bank's extensions of credit to, and purchase of assets from, an affiliate engaging in nonbanking activities. At a minimum, these would include the limitations contained in sections 23A and 23B of the Federal Reserve Act.

In general, section 23A prohibits a bank from extending credit to, or purchasing the assets from, an affiliate in excess of 10 percent of the bank's capital (an aggregate cap of 20 percent of capital is established for bank loans to all affiliates). While there are no quantitative constraints for loans collateralized by U.S. Government securities, section 23A does require that bank loans to affiliates be collateralized in varying amounts, depending on the type of collateral provided. Section 23B requires that transactions between a bank and its affiliates be on terms, including credit standards, that are substantially the same (or at least as favorable to the bank) as those prevailing at the time for comparable transactions with non-affiliated companies.

I believe that these restrictions should continue to apply to extensions of credit by an insured depository institution to an affiliate engaging in nonbanking activities.

Q.2. How does the Federal Reserve Board differentiate its actions in granting new powers to banks from those taken by Congress when it deregulated the savings and loan industry in the early 1980s?

A.2. The Board approves nonbanking activities for bank holding companies pursuant to a specific Congressional grant of authority in section 4(c)(8) of the Bank Holding Company Act. In acting on section 4(c)(8) applications filed by bank holding companies seeking to engage in new activities, the Board is required to determine both that the activities are "closely related to banking" and that any possible adverse effects, such as undue concentration of resources, decreased or unfair competition or unsound banking practices are outweighed by benefits to the public.

In approving a new activity, the Board has generally established a framework of conditions and limitations intended to minimize the potential adverse effects associated with a new activity. In particular, the Board seeks to minimize any risk from the expanded activity that would affect adversely either the financial condition of federally insured depositories affiliated with the company engaging in the new activity or the resources of the federal safety net. For example, in the securities orders the Board established the following approach to achieve these objectives:

(1) the securities activities could not be conducted directly or indirectly by a federally insured bank, but rather only in a bank holding company subsidiary. That subsidiary must be owned, capitalized, funded and controlled by the bank holding company, and not by an insured bank or thrift;

(2) this legal separation available through the holding company subsidiary is reinforced by certain prudential limitations placed between the bank and the section 20 company;

(3) the Board required bank holding companies seeking to expand their debt and equity securities powers to demonstrate a strong capital position or to raise additional capital to offset the investment; and

(4) the Board recognized the need for close supervision of entry into these activities.

Q.3. Has the Board expressed to the Treasury its opinion of pass-through federal deposit insurance on banks or guaranteed investment contracts (BIC's, GIC's)? If so, what is the Board's position regarding pass-through insurance?

A.3. The Board has not formulated its position regarding federal deposit insurance coverage of BICs. The Board believes that further study is needed of the risks to the issuer of a BIC, as well as of whether the Federal Deposit Insurance Act was intended to cover such contracts.

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

THURSDAY, JULY 19, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Garn, D'Amato, Heinz, Dodd, Shelby, Dixon, Wirth, and Kerry.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order. Let me invite all those who are here to find seats, and let me welcome those in attendance this morning. And welcome our witness, Richard Breeden, Chairman of the Securities and Exchange Commission.

The committee is hearing testimony today from Mr. Breeden on financialization and deposit insurance reform. This is the second of our hearings on these topics, which highlight testimony from the heads of our financial regulatory agencies.

Chairman Breeden brings a particularly unique perspective to the issue of financial modernization. He has been involved in this issue since the 1980's, when he served as the Staff Director of the Task Group on Regulation of Financial Services under then Vice President George Bush.

The erosion of the old barriers among financial industries by market forces and the exploitation of statutory loopholes that began in the 1980's has continued in the 1990's.

Many legislative proposals have been made to expand and regulate powers and affiliations of financial institutions. These proposals merit very careful consideration.

But, two conditions must be met before Congress enacts Financial Modernization legislation.

First, the Financial Deposit Insurance System must be in reform, and proposals that may increase the risk to the insurance funds and to taxpayers cannot proceed until the current system is reformed to adequately incorporate mechanisms to control risk.

Second, our system of financial institutions regulation needs rationalization and modernization. The regulatory body that oversees and regulates financial services' conglomerates must be able to adequately monitor and respond to all of the risks present in financial conglomerate's portfolios and then, in turn, in the financial system as a whole.

We have asked Chairman Breeden to testify today on these two issues: Deposit insurance and regulatory structure reform.

In addition, we have asked him to address what new powers or affiliations banks should be granted and what protections for the deposit insurance fund should be adopted in conjunction with those powers.

And so we very much look forward to having his thoughts today.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **GARN**. Thank you, Mr. Chairman.

First of all, let me note that last night, the Senate passed S. 647, Securities Law Enforcement Remedies Act. And I wanted to mention that and, certainly, give credit to Senator Dodd and Senator Heinz for their work on that legislation. Sometimes, when things go so quickly and easily by voice vote, nobody takes notice of them.

It is a pleasure for me to welcome Richard Breeden before the committee this morning. I am particularly delighted we have another stalwart voice in the effort to modernize our outdated financial services laws. I know that he has a strong interest in the issues before us, not only in his capacity as the Chairman of the Securities and Exchange Commission, but also stemming from his role as the Staff Director of the Bush Task Force on Financial Services Reform.

I think it is especially important that we get the perspective of the SEC Chairman on the need for comprehensive reform. The ongoing debate over Glass-Steagall Reform has long been characterized as simply a banking issue. Unfortunately, this has resulted in far too much parochial industry bickering, which has tended to obscure the broader issue of competitiveness.

Clearly, when we are talking about comprehensive financial services reform, we are talking about an issue fundamental to our country's economic well-being. What really amazes me is that, while there is virtual unanimity on views with respect to the need to modify Glass-Steagall, McFadden and our other financial services laws, we continue to demonstrate a remarkable inability to get anything done.

As everybody knows, I have sung the same song for the past 16 years. In addition, all of our principal financial regulators have joined the chorus, recognizing the importance of restructuring our financial services industry in order to maintain our competitive position in the world economy.

The chairman of the nation's central bank sounded the refrain last week. The chairman of the agency responsible for overseeing our nation's capital markets, does so today. And, I trust, the Secretary of Treasury, Chairman of the FDIC and OCC will do likewise in the next 2 weeks.

I guess I'm confident, if we could sit down in the room together, it wouldn't take long to work out something that we could all agree on. I just wish after all these years we could convince our friends in the House of the same need.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I want to join Senator Garn in welcoming Richard Breeden to the committee as the committee continues to explore how best to enhance the safety, efficiency and the competitiveness of our financial services industry. I have a few other words I want to say, but I want to thank Senator Garn for his kind words about our late night action on S. 647, the Securities Law Enforcement Remedies Act.

Senator Dodd deserves a great deal of credit for that legislation. It was a pleasure to work closely with him. It gives Chairman Breeden some important new authority to seek and impose civil monetary penalties for a range of securities law violations.

As you know, it will also give you new cease and desist authority. I think this committee, and the Senate, last night in particular, have sent a very clear message that we look forward to a continued strong enforcement program at your agency, the SEC.

I might add we expect you to use that new authority aggressively, but wisely.

Mr. Chairman, regarding the subject of today's hearings, it's perhaps worth noting that Chairman Breeden served as Staff Director of the Task Group on Regulation of Financial Services, chaired by a fellow—I can't remember his name, but he was Vice President. Oh, yeah, it was George Bush.

The Task Group published the so-called Blueprint for Reform.

There's been a lot of red ink in the Savings and Loan Industry since the Blueprint was drafted 5 years ago. Many banks still yearn to graze in what they consider the greener pastures of securities, insurance and real estate firms.

If we've learned anything from our previous 10 hearings on the subject, it is that issues of Federal deposit insurance reform and restructuring the financial services industry are simply not black and white.

Mr. Chairman, notwithstanding the diligent efforts of this committee and the Senate to develop legislation to modernize our financial system, the only thing that has passed thus far is time.

Financial markets and the international competitors have not stood still. I look forward to determining to what extent Chairman Breeden's views on financial modernization have also changed over time in response to the changing circumstances and developments.

The CHAIRMAN. Thank you, Senator Heinz.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I am certainly delighted to see Chairman Breeden here. And I must say that I found his testimony, his prepared remarks, very interesting. And I agree with him.

I find it to be of great interest that Mr. Breeden indicates the necessity for firewalls as it relates to protecting depositors' insurance against undue risk. And we're talking about the taxpayers. And also as it relates to self-dealing, tie-ins, et cetera, the necessity of them, that Chairman Greenspan indicated almost to the contrary that, indeed, they have been found to be ineffective and questioned their utilization.

As we move into the area of attempting to deal with the changes that we have today, I think financial modernization is something that we have to deal with. It will have to be the necessary requisite reform.

But, absent their being the kind of protections that Chairman Breeden has put forth, I think that we are bound to repeat the past lessons of failure that we saw in the S&L debacle.

And this Senator is very much concerned that, as we move in to fairness and competitiveness, as Senator Garn has indicated, we want to be competitive. But, to be lulled into the false sense of security that, well, let's let the big banks do everything without there being the necessary protections both for their competitors and for the American taxpayers would be a tragic error.

And I am heartened. It would seem to me that Chairman Breeden recognizes this and certainly his prepared remarks touch on this.

And this is something that I think is absolutely—you're going to get more pressure put on you to conform to the party line—and I don't mean Republican or Democrat, but to the whine of the big banks: "Oh, don't worry about that. You know, we can handle it. We'll just put it in a separate sub and somehow that will—and don't worry about the firewalls because that seems to be the party line that is taking place."

I hope, Mr. Chairman, that you stick to your guns and see to it that the American taxpayer, and fair competition, is protected.

Mr. Chairman, I'm going to ask that my remarks be placed in the record. I have extensive remarks, written in their entirety.

The CHAIRMAN. Very good. Thank you.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, today the committee continues its consideration of financial services modernization. I join you in welcoming the Chairman of the U.S. Securities and Exchange Commission, Richard Breeden.

Dramatic changes in both the domestic and international financial environments have brought us to a point where it is no longer relevant to discuss whether we should undertake major reform of the legal structure of the financial services industry. These changes make reform imperative. The question is how do we go about it.

I support the effort to modernize the financial services industry to increase the availability of innovative financial products and services for consumers, business, and Government at the lowest possible cost—provided that we do so in a way that improves the safety and soundness of the Nation's financial system. That is why I introduced the Depository Institution Affiliation Act with Senators Cranston and Garn during this Congress.

However, recent testimony form Chairman Greenspan outlining the Federal Reserve Board's doubts about installing effective firewalls has revived serious questions about how we can modernize the financial industry without exposing the taxpayer to significant risk. I am not willing to support major reform of the existing system if its price tag is another financial industry bailout down the road.

Over the last few years, I have come a long way on the issue of making structural changes to the financial system. I have done this because I recognize that it is necessary to allow financial diversification in today's turbulent and competitive economic environment. This is one of the lessons of the problems of the savings and loan industry.

However, another lesson from the savings and loan debacle is that we must design reform that will protect the taxpayer sufficiently from any possibility of a Federal bailout. Financial institutions should be able to engage in broader, more comprehensive activities, but they should do it with their own money at risk, not the Government's. Uncle Sam hasn't even filled in the final number on the check to pay for the savings and loan industry; lets not write another blank check that old Uncle Sam will have to sign.

Finally, provided that these concerns are met, any modernization of the financial services industry must ensure that the new system is competitive and fair. I am pleased to see that Chairman Breeden has stated that "should Congress determine to repeal the Glass-Steagall Act's restriction on affiliation between banks and securities firms, it must simultaneously amend the Bank Holding Company Act of 1956." "Banks should not be free to acquire securities firms, while many securities firms and other major U.S. firms remain as a practical matter, unable to acquire banks." Mr. Breeden's testimony today echoes this point.

I agree with this sentiment. The D'Amato-Cranston-Garn bill follows this principle, which I support because it is the only way to ensure a truly competitive financial services industry.

Thank you, Mr. Chairman.

The **Chairman**. I want to say, before calling on Senator Dodd, note has been taken of the passage last night on the Senate floor of the Securities Law Enforcement and Remedies Act, and how important that legislation is.

And I want to personally commend you and also Senator Heinz for your very important work in the subcommittee on that topic. And I think what we have done together as a committee to get that legislation drafted and enacted and through the Senate has been a very important step and very much deserving of comment with respect to your role in that.

OPENING STATEMENT OF SENATOR DODD

Senator **Dodd**. Thank you, Mr. Chairman. And I thank you for your help, and of course John Heinz, who is an invaluable partner in these efforts; and the SEC, really. They did a tremendous job in moving that product up to us and then working with us on it. And we're just hopeful that, before too long, we can get the Market Reform Bill adopted as well. That's a very important element in this formulation of getting us back on the right track.

And so we thank you as well, Mr. Chairman, for your efforts on our behalf on that particular piece of legislation as well.

I am anxious to hear Dick's comments here this morning, if I could just make a comment or two.

Last week—I think it was a week ago. Time elements here—we had the hearing on the SEC-CFTC issue, which is a hot issue. And in a pique of frustration more than anything else, I suggested that these two agencies ought to be able to get together and come up with a formulation here that would help resolve that particular problem.

And I want to say to Dick Breeden and his staff and others that that characterization in my own view was a little rough on the SEC. They've been doing a remarkably good job.

I guess my frustration was more pointed toward Nick Brady, and he knows about it because we've talked about it. I am frustrated over the fact that we are getting people within the same administration fighting with one another over something where there ought to be, it seems to me, an effort to resolve it.

But, on the record here and publicly, I want to apologize to Dick and to members of his staff. Those words should have been moderated a bit. They've been doing an excellent job, just a first-rate job.

And I can't be happier to be chairing a subcommittee with jurisdiction over this area and to be able to work with a chairman and work with a commission that is just keeping the public's interest as the number one priority.

And you really deserve a great deal of credit for that. And I'm anxious to continue working with you on these issues and others in the coming weeks and months.

Thank you.

The CHAIRMAN. Thank you, Senator Dodd.

Chairman Breeden, we'll make your full statement a part of the record. Unfortunately, we got it quite late last night, so it has not had the time for the kind of analysis that we would all like. But, we'll make it a part of the record and would like your summary comments now.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Chairman BREEDEN. Thank you, Mr. Chairman.

Before taking up this morning's topic, I would like to echo the sentiments of Chairman Riegle and other members of the committee and congratulate and thank this committee for your help in moving S. 647, the Enforcement Remedies legislation forward. In a very real way, we believe that legislation will allow us to better protect 50 million Americans who participate directly and indirectly in the Nation's securities markets.

The system that we have now is strong, but this legislation is an example of Congress and the Commission and other interested groups working together to allow us to make it better.

We believe that the provisions of that legislation will give us important authority to do a better job in policing fraud and other forms of abuse in the securities markets.

We have every intention of aggressively using the authorities granted by that bill if the House follows suit and passes it, which we are very optimistic will occur. But, at the same time, I can assure you that we will do our very best also to use that authority wisely and carefully.

I really appreciate the very substantial efforts of the committee and the staff to help us by moving that legislation along so rapidly.

I appreciate the opportunity to appear today on behalf of the Securities and Exchange Commission to discuss the need to modernize the regulation of financial services in the United States and the implications of the choices now before us for financial services reform.

At the outset, let me congratulate you, Mr. Chairman, and Senator Garn and the other members of the committee for your determination to examine these important issues.

Modernizing the Glass-Steagall Act, the Bank Holding Company Act, and other U.S. financial laws has been actively debated in the Congress for more than a decade. However, I don't think that the issue has ever been more timely.

Through the so-called EC–92 process, the 12 European community countries are taking rapid and dramatic steps to build an integrated financial market with few internal barriers to competition.

Similarly, Japan is actively considering revisions to article 65, their counterpart to Glass-Steagall.

Thus, it is extremely timely for this committee to consider what steps the United States should take to make sure that we remain fully competitive here in the United States.

The facts are that foreign competition to U.S. markets is on the rise and foreign market share in our own domestic financial marketplace is also steadily on the increase. We have to take a serious look at things that can be done here at home with our own system to make sure that we remain competitive and that our financial services firms are as successful in the future as they have been in the past.

I think the concept of a USA–92 to match the type of competition that we will face in the 1990's from abroad is an extremely important and timely effort and one which the Commission intends to work on with you quite actively.

It is worth observing at the outset, as Senator Garn indicated, that the issue before us is not simply whether banks deserve greater powers. It also is not simply a question of how to reform deposit insurance so that we can permit banks to have greater powers.

The issue is what kind of financial change would most benefit the American public and most strengthen the overall U.S. economic performance.

Every interest group, and I might add, every regulatory agency, including the SEC, should be held accountable to change to serve the national interest and to achieve a strong, efficient and successful financial system.

For its part, Congress must be prepared to compel parochial interests to be flexible and to prevent special interests from either exposing the public to greater costs or from preventing change that would benefit the entire country.

My colleagues and I at the SEC stand ready to work with the Congress in fashioning legislation that would promote competition, while maintaining public safety and ensuring to the greatest possible degree the continued strength and competitiveness of U.S. financial markets and all our financial firms.

In fashioning change, Congress has to take care to proceed carefully and systematically. Change in our existing system should not occur unless we can satisfy ourselves that any proposed new statutory framework would be better than the current system. We must also be satisfied that new problems involving stability, risk to the taxpayers, or risk to consumers will not be created that would be more costly than the benefits of reform.

In particular, new activities for banks need to be accompanied by reform of deposit insurance to reduce significantly the aggregate exposure of the taxpayers, to introduce greater market discipline, and to eliminate distortions in competition.

Given current policies with respect to the failure of large banks, the current extent of deposit insurance coverage, and the rapidly falling level of FDIC resources in recent years, it appears that the Federal budget and taxpayers and not just shareholders might absorb any significant losses by banks and their affiliates, if they occurred in undertaking new types of activities.

Therefore, it may be unwise to expand bank powers significantly until, at the same time, we adopt reforms to assure that the risks of those activities will be borne by the shareholders of holding companies or banks and not by the deposit insurance fund and the taxpayers.

The question then is not should there be reform, but what specifically should be accomplished?

As an initial matter, we should not, in our judgment, adopt a universal banking system. Universal banking would extend the deposit insurance umbrella to a wide range of securities, insurance and other activities that are completely unrelated to the purpose of deposit insurance. That alone, I believe, makes universal banking an unacceptable alternative for structural reform here in the United States, notwithstanding its wide-spread usage in Europe and other countries around the world.

Use of a holding company structure would avoid many of the problems of universal banking. However, the present Bank Holding Company Act of 1956 comes with its own excess baggage and considerable unnecessary costs.

For example, the act bars commercial firms from acquiring banks, the so-called separation of commerce and banking. If left unchanged this provision would effectively make a repeal of Glass-Steagall one-sided. Banks would be permitted to acquire securities firms but many of the largest U.S. securities firms, would be unable to acquire banks because those securities firms are presently affiliated with commercial entities.

Indeed, depending on your characterization of the types of activities, nine of the 20 largest securities firms currently have affiliates which are engaged in activities that would not be permissible for bank holding companies under the existing statute.

A one-way competition is hardly a recipe for fair competition, for economic efficiency, or for making capital available to banks. And, in our judgment, reform has to be a two-way competitive street or there should be none at all.

Furthermore, as a result of the Bank Holding Company Act's current prohibitions, commercial firms with demonstrated success in lending and other activities closely related to banking, such as

General Electric through G.E. Credit Corp., consumer credit such as Sear's Roebuck or General Motors, real estate finance such as Prudential Insurance, and other financial services, including American Express and Equitable Insurance, for example, are blocked from investing capital or providing management expertise to U.S. banks, although, ironically, they may be allowed to acquire foreign banks.

In the United States today, the vast majority of available capital is concentrated in commercial firms, whose activities extend far beyond those permitted to bank holding companies under the Bank Holding Company Act.

And with the emphasis that our colleagues in the bank regulatory agencies place on having banks increase their capital base, it is ironic that the largest potential source of that capital from within the United States of America, commercial firms, is exactly the category of firms that are currently prohibited from investing in U.S. banks.

In 1989, the Fortune 500 firms and that list does not include banks, had $719 billion in shareholders' equity in the aggregate, more than 3.5 times the shareholders' equity level of all the commercial banks in the United States.

As a result, maintaining the separation of banking and commerce removes an enormous potential source of badly needed capital for the banking industry.

Experience in the securities industry suggests that this separation may not be necessary and, indeed, in some cases, may be counter-productive.

As I indicated, many of the largest securities firms in the United States are owned by major commercial enterprises, and firms that include nonfinancial activities.

These parent firms have provided capital for needed restructuring and have provided liquidity in times of financial adversity, calming the market during difficult periods.

The affiliation between securities firms and commercial companies does not appear to have resulted in the types of abuses upon which the prohibitions in the Bank Holding Company Act are predicated. These large firms do not appear to have abused their affiliate relationships or, as a result of their size, engaged in anticompetitive practices. They have not crowded out specialized investment banking organizations and firms that do not have commercial affiliates, such as Goldman-Sachs, Morgan-Stanley, A.G. Edwards, Merrill-Lynch. Such firms continue to operate profitably and compete effectively against firms that do have commercial affiliates.

What has worked in the securities industry should likewise work in the banking industry, so long as appropriate regulation and firewalls are, in fact, maintained.

Paradoxically, while we say we prohibit the affiliation of banking and commerce, the existing system already permits the combination of banking and commerce here in the United States. Unfortunately, the combination is limited to U.S. banking and foreign commerce.

Under the Federal Reserve Board's regulation K, foreign banks that are part of commercial groups overseas are free to acquire

U.S. banks. That has, in fact, occurred on many occasions. Mitsubishi Bank Limited, for example, a large Japanese Bank, owns the Bank of California here in the United States.

And, yet, among the largest shareholders of Mitsubishi Bank are Mitsubishi Heavy Industries, Mitsubishi Corp. and other members of the Mitsubishi group. So that there are indirect relationships between commercial firms in Europe, Japan, and throughout the rest of the world and United States banks. It seems odd that United States law would prevent General Electric, IBM or other successful United States commercial firms from having the same types of relationships here at home that overseas commercial enterprises may have.

Another element in streamlined Bank Holding Company Act would allocate overall supervision of the holding company to the Federal agency with regulatory oversight over the financial services subsidiary with the largest capital investment.

A similar type of system in which regulation at the holding company level was vested in the most appropriate agency—an appropriateness based on the regulator of the largest operating subsidiary—was recommended by the Bush Task Group in 1984, with the concurrence of Federal Reserve Board Chairman, Paul Volcker.

Indeed, Gerry Corrigan, in his recent testimony before this committee, suggested support for a similar concept. Mr. Corrigan stated that if there is regulation at the holding company level, it ought to be tailored to the agency that regulates the largest operating subsidiary.

If the largest operating subsidiary happens to be a bank, then the appropriate agency should be a bank regulator.

If the largest operating subsidiary is a securities company, then a securities regulator ought to be at the parent level.

Likewise, the functions of a holding company regulator could be streamlined and confined to policing restrictions on inter-affiliate transactions, helping to coordinate exams, and monitoring of other risks at the holding company level, and of affiliates that are not otherwise regulated.

These functions should include, we believe, stand-by auditing and examination capability to go after problems that may exist in the holding company or in holding company affiliates where there is reason to believe that a problem is developing.

Such changes to the existing Bank Holding Company Act would be a step in the right direction. However, before we attempt to squeeze a modern financial services industry into the straightjacket of the existing Bank Holding Company Act, we should challenge our longstanding assumption that it is necessary or desirable to impose a system of parent level holding company regulation in addition to the obvious and absolutely necessary regulation of banking and securities subsidiaries.

Therefore, Congress, as part of a comprehensive overhaul of financial services, should consider repealing the Bank Holding Company Act. That act could be replaced by a system in which the regulator of the firm's bank or broker dealer regulates that subsidiary and also conducts oversight of the condition of the overall entity.

Such a system would be similar to the one we already use for large public companies in this country. Sears, General Electric, General Motors, Exxon, Mobile, American Express, and IBM all routinely have separate operating subsidiaries, oftentimes in financial activities.

They are, in fact, holding companies. And, yet, we do not feel it necessary that the status of being a holding company requires a particular U.S. Government agency to serve as a regulator of the consolidated company.

Where a holding company is engaged in a specific activity that is normally regulated, then, of course, the holding company's operations in that area should be subject to the same type of regulation.

Today, the SEC regulates the operations of Kidder-Peabody and Dean-Witter. We believe we should know of, and be able to monitor, the financial condition of the parent firm. I would certainly second Senator Dodd's comments on the importance of the pending Market Reform Act to enable us to do that.

But, at the same time, we do not think it necessary or appropriate to regulate how General Electric makes jet engines or to decide whether Sears should be authorized to sell paint.

Under the approach which we have suggested, which I will refer to as the subsidiary oversight model, a holding company would be free to decide for itself in what lines of business it wanted to engage without pre-approvals by a Federal agency.

However, each of the holding company's financial service affiliates would, of course, be subject to the same type of regulation that exists for other companies engaged in that activity. Each such regulator, whether it was a regulator of a bank or a broker dealer or an insurance company, would be entitled to require not only information as to the operating company it regulates, but also information on the overall financial status of the holding company and any other material activities of the holding company parent.

The regulator of each banking and securities operating subsidiary would have the power to require the disclosure of all inter-affiliate financial activities.

In addition to regulating the capital, prudential standards, and other normal business of the securities or banking subsidiary exactly like other banks, broker dealers or insurance companies are regulated, each line regulator would be responsible for establishing policies to limit the use by the holding company of its subsidiaries' net worth or credit.

These policies should include limits by the regulator of the bank or broker dealer on the ability of the subsidiary to pay dividends up to the parent corporation, or the ability of the subsidiary to make loans to the parent corporation or any other affiliated company. In addition to the power of the line regulator to monitor the holding company's overall condition, each regulator would have residual authority to respond to financial instability in the holding company by taking immediate action to ensure that the capital of the subsidiary bank, subsidiary insurance company, or subsidiary broker/dealer capital is not impaired.

The effectiveness of a regulatory system based on regulation of the operating companies—the banks, the broker dealers—would depend upon, among other things, the existence of serious capital and accounting rules in each regulated entity.

Capital not only provides a cushion in the event of financial difficulties of the subsidiary, but also provides a cushion against the impact of financial problems in any parent holding company or other affiliate.

This capital cushion is essential to enable regulators to take action before capital is completely depleted and before a deposit insurance or SIPC fund must step in to make up the difference.

However, the power to set capital standards is not enough. In addition, the specialized regulator of a subsidiary of a holding company should have early intervention authority, so that it could step in instantaneously when a regulated entity's capital position is threatened or falls below a mandated level.

At all times, the line regulator of such a company should have the authority to prevent the holding company from depleting the capital of the subsidiaries.

As the failure of Drexel Burnham Lambert group indicates, however—and it's important to recognize this—it will not be possible in many circumstances to avoid contagion of a financial problem within a combined firm.

Even a well-capitalized regulated subsidiary may simply be unable to retain the necessary financing or liquidity to continue long-term operations if its parent is in sufficiently serious trouble.

Through rigorous oversight and high capital requirements, the subsidiary oversight model is designed, however, to allow the regulated banking, securities or insurance entities to be, in effect, uncoupled from a failing parent, exactly like railroad cars can be uncoupled from the rest of the train.

Any such subsidiary then could be sold, liquidated or dealt with as necessary to prevent or minimize harm to the financial system as a whole, to the entity's customers, to the relevant insurance fund and, ultimately, to the U.S. taxpayer.

The subsidiary oversight model will, of course, require cooperation and coordination among regulators of bank and broker dealer affiliates, but this approach worked well in the collapse of Drexel.

The Commission and the Federal Reserve Bank of New York, along with the Treasury Department and the Federal Reserve Board, were in constant contact. During the crisis, each agency supervised the operations and the wind-up of the entity in its area of responsibility, the broker dealer handled by the SEC, the Government bond dealer handled by the Federal Reserve Bank of New York.

And even though in that case there was no agency with overall holding company authority, Drexel's failure did not cost U.S. taxpayers a single penny.

We believe that experience proves that the existence of a holding company regulatory entity is not an absolute corollary to designing a system in which losses in one part of a consolidated entity can be prevented from spreading over into insurance funds and impacting the taxpayers.

The subsidiary oversight system would also make use of public disclosure as a regulatory tool. Thousands of public investors and industry analysts are far more likely to spot potential financial problems, and spot them early, than any single Government regulator can be expected to do.

To do so, however, it is essential that the market receive information that is complete, accurate, timely and fully comparable to information available about other public companies.

Thus, the subsidiary oversight model, based generally on the securities mode of regulation, would be, in our view, more efficient and less intrusive than expansive forms of substantive regulation by any single holding company regulator.

Strong and appropriate firewalls would be used to control intermingling of risks between various subsidiaries, as well as to control any upstreaming of funds to the parent when there is a risk of insolvency.

The key importance of firewalls is not that they prevent failure from occurring. It has to be recognized that, even with firewalls, a big enough problem in some part of the consolidated entity will cause a failure. But, that's not the purpose of the firewalls.

The purpose of the firewalls is not to ensure that companies will never fail, but rather to ensure that the regulators are able to manage failure when it does occur. Firewalls will prevent intermingling of exposures that will spread a problem automatically from one type of subsidiary that does not have any public safety net into another type of subsidiary, such as a bank, that does have a public safety net.

Because firewalls serve to maintain capital of the regulated entities intact, they provide regulators with greater time and flexibility to manage failure in periods of a holding company's instability.

Accordingly, the Commission believes that carefully tailored firewalls are an essential component of any new regulatory system.

As Congress looks to the question of whether a "USA-92" concept, that is, some form of comprehensive overhaul of the U.S. financial services system should be adopted, we believe that more than simply changes to the Bank Holding Company Act and the Glass-Steagall Act ought to be considered.

We share the concerns expressed by Chairman Greenspan that the interstate branching rules, for example, contained in the banking laws ought to be repealed. We believe those rules force activity across State lines to be conducted in a higher cost form of organization; institutions ought to have the flexibility to branch across State lines as well as to acquire separate banks across State lines.

Similarly, we believe that the Blue Sky requirements, in which we have not one securities law but 51 securities laws in this country, should be re-examined. The objective of this reexamination is not necessary to abolish these programs. Rather, to make sure that we do everything we can to remove unnecessary costs and barriers to the liquidity of our securities markets and to the efficient operations nationwide securities firms.

We also believe that the exclusivity provision of the Commodity Exchange Act, which create absolutely avoidable regulatory costs and inefficiency, should be reevaluated along with a number of other similar statutory provisions that are not necessary to create safety, but that impose costs that reduce the competitiveness of U.S. firms in world markets.

Similarly, deposit insurance should be overhauled to put it on a sound financial footing and to eliminate public subsidies and incentives for undue risk. Such an overhaul needs to be part of an overall comprehensive program.

In conclusion, this Nation's capital markets are a vital economic asset. The $3.5 trillion in equity securities and the equity securities market are, in our view, perhaps a somewhat biased view, the crown jewels of the U.S. capital market system. In order to protect that market and all the other segments of the U.S. financial system, we should modernize our financial regulatory structure, but only in a sensible, careful and comprehensive manner.

In all cases, we should be prepared to reduce competitive barriers whenever and wherever we can do so, as long as the result will not weaken stability, artificially distort competition through public subsidies, or incur greater risk to the integrity of the market, to the U.S. taxpayer.

This task of modernizing financial services is a daunting one, but it is one that should proceed as swiftly as possible.

The U.S. financial services industry faces intense foreign competition from firms that may have significantly greater flexibility and lower cost structures as a result of their system of oversight. That foreign competition is not going to go away. It is going to get stronger each and every year, and we cannot assume that the kinds of problems resulting from a lack of competitiveness that we have seen in other U.S. industries somehow cannot occur in the financial market.

It can and, indeed, in many respects, is happening. And it's time for us to do everything we can to make sure that we clear the competitive decks so that the U.S. financial firms are free to use their talent in a successful battle for opportunities in world financial markets.

To make this work, it is imperative that all parties interested in a sound and efficient financial services industry work together to design a sensible and prudent means of comprehensively modernizing the U.S. regulatory system.

If we all work together rather than against one another, we can develop a new system that will keep our firms and markets strong, safe and profitable in an intensely competitive global financial market.

Thank you very much.

[The complete prepared statement of Richard C. Breeden follows:]

TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING FINANCIAL SERVICES MODERNIZATION

BEFORE THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JULY 19, 1990

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING FINANCIAL SERVICES MODERNIZATION

BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS OF THE UNITED STATES SENATE

JULY 19, 1990

Chairman Riegle and Members of the Committee:

I appreciate this opportunity to appear today, on behalf of the Securities and Exchange Commission, to discuss the need to modernize the regulation of financial services in the United States and the implications of the choices now before us for our financial services.

At the outset, let me congratulate you, Mr. Chairman, and Senator Garn and the other members of the Committee for your determination to examine these important issues. Modernizing the Glass-Steagall Act, the Bank Holding Company Act of 1956 ("BHCA") and other U.S. financial laws has been actively debated in Congress for at least a decade. However, I do not think that the issue has ever been more timely. Through the "EC 92" process, the 12 European Community ("EC") countries are taking rapid and dramatic steps to build an integrated financial market with few internal barriers to competition. Similarly, Japan is actively considering revisions to Article 65, its counterpart to the Glass-Steagall Act. Thus, it is extremely timely for this Committee to consider what steps the United States should take to make sure that we remain fully competitive.

It is also worth observing at the outset that this is not an issue of whether banks deserve greater powers. It is also not a question of how to amend deposit insurance to permit banks to have greater powers. The issue is what kind of financial change would most benefit the American public and strengthen overall U.S. economic performance. Every interest group, and every regulatory agency (including the SEC), should be held accountable to change to serve the national interest in a strong, efficient and successful financial system. For its part, Congress must be prepared to compel parochial interests to be flexible, and to prevent special interests from either exposing the public to greater costs, or preventing change that would benefit the entire country. My colleagues and I at the SEC stand ready to work with the Congress in fashioning legislation that would promote competition, maintain public safety and ensure to the greatest possible degree the continued strength and competitiveness of U.S. financial markets and all our financial firms.

I. The Need for Modernization

Few matters are more important to the economic health of this nation than the strength of our financial system. The financial services industry is of major importance to our economy, not only because of the people it employs, but because of the vital role it plays in harnessing savings for investment and thereby creating economic opportunity and jobs. The continued growth and prosperity of our economy will be significantly affected by the level of savings and the cost of capital investment. The long-term health and competitiveness of our financial services industry is therefore an important element in building the economic muscle our society will need for the future.

A. The New Financial Services Environment

Technology and innovation have transformed the character of financial markets, and global competition now touches each element of the U.S. financial services industry. In the securities industry, a recent study found that gross cross-border equity investments in 1989 reached $1.6 trillion.[1] In the last ten years, foreign investors' gross purchases and sales of U.S. securities in U.S. markets (predominantly government securities) grew from $198 billion to $4.7 trillion per year. Similarly, U.S. investors' purchases and sales of foreign securities increased from $50 billion to $700 billion annually over the same period. These large cross-border capital movements coincided with intensified competitive pressures on the domestic financial services sector and, in some cases, reduced domestic and international market share of U.S. firms.[2]

The sobering consequences of such global trends may be observed in the banking industry, where the statistics are striking. Total foreign ownership of U.S. banking assets now exceeds six times what it was only a decade ago [see Figure 1].

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[1] Salomon Brothers Inc., "International Equity Flows -- 1990 Edition" (July 6, 1990).

[2] See John H. Gutfreund, "The State of the U.S. Financial Service Industry," Testimony before the U.S. Senate Committee on Banking, Subcommittee on Securities (Mar. 6, 1990).

Almost 150 U.S. banks with nearly $165 billion in assets are now owned by foreign entities. In addition, 281 banks from 56 countries now have nearly 700 full service offices in the United States.

By contrast, foreign assets of U.S. banks have been relatively static throughout the decade, and U.S. banking institutions have also seen their relative position globally fall sharply. In 1970, seven of the twenty-five largest banks in the world were headquartered in the United States. Today, only one of the twenty-five largest banks in the world is a U.S. firm.[3]

Insurance has also experienced significantly greater foreign competition in recent years. Foreign-owned insurance companies roughly tripled their domestic assets between 1980 and 1987 [see Figure 4].

Technological change and innovation have also transformed the domestic financial services sector, with new products being created that in many cases have blurred distinctions between industry categories. For example, many banks today are engaged in the sale of private placements [see Figure 5] and the packaging and sale of securitized loans, activities that are difficult to distinguish from such traditional securities activities as underwriting. Many banking products (such as letters of credit supporting municipal bonds) are very similar to certain forms of insurance (such as insurance on municipal bonds). Some securities activities, such as the sale of commercial paper [see Figure 6], bear strong resemblances to a bank's traditional commercial lending and loan syndication activities.

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[3] Figures 2 and 3 show the relative asset shares and capital shares of the world's 25 largest banks and securities firms by home country of firm at year-end 1988.

B. Weaknesses of the Existing Financial Structure

The existing U.S. financial regulatory structure includes substantial barriers to competition and efficiency. It imposes significant unnecessary costs on financial services firms and, ultimately, on the users of those financial services.

1. The Glass-Steagall Act and the Bank Holding Company Act

The Glass-Steagall Act and the BHCA impose major costs on the financial system.

a. Affiliation Restrictions

The combined effect of the Glass-Steagall Act and the BHCA is to prevent most affiliations between commercial banks and securities firms. This rigid separation between banking and securities activities is no longer necessary or desirable.

The BHCA also contains a rigid and artificial separation between banking and commercial firms. Commercial firms with demonstrated success in lending and other activities closely related to banking (such as General Electric, through General Electric Credit Corporation), consumer credit (such as Sears Roebuck and General Motors), real estate (Prudential Insurance), and other financial services (such as American Express and Equitable Insurance) are thus prohibited from investing capital or management expertise in U.S. banks, although they may be able to acquire foreign banks.

In the United States today, the vast majority of available capital is concentrated in commercial firms whose activities extend far beyond those permitted to bank holding companies under the BHCA [see Figure 7]. As a result, maintaining the separation of commercial banking from non-bank ownership removes an enormous potential source of badly needed capital for the banking industry.

Moreover, repealing the Glass-Steagall Act alone, while leaving the BHCA intact, would compound our problems. Banks could acquire securities firms, while at the same time many of the largest U.S. securities firms (those that already are affiliated with insurance companies or commercial firms) could not acquire banks.

The separation of banking and commerce is an historic tradition in this country. It has long been feared that any combination of banking and commerce would result in such problems as overconcentration of banking assets, conflicts of interest, and unfair competition. However, experience in other U.S. industries or in banking overseas does not provide any strong factual basis for such fears. In this regard, the experience of the securities industry is particularly instructive. Many of the largest U.S. securities firms are owned by major commercial enterprises or firms that include non-financial activities. For example, Kidder, Peabody is owned by General Electric; Shearson Lehman is owned by American Express; Dean Witter is owned by Sears; and Donaldson, Lufkin & Jenrette is owned by Equitable Insurance. This participation in the securities business by firms engaged in other areas of commerce appears to have benefitted the securities industry significantly. These parent firms have provided capital for needed restructuring and liquidity in times of financial adversity, calming the market during difficult periods.

Furthermore, the affiliation of securities firms with these commercial conglomerates does not appear to have resulted in the abuses upon which the BHCA's prohibitions are predicated. For example, these large financial/commercial firms do not appear to have abused their affiliate relationships or, as a result of their size, engaged in anticompetitive practices. In fact, firms with commercial affiliates have not crowded out specialized investment banking organizations. Independent securities firms such as Goldman Sachs, Morgan Stanley, A.G. Edwards, and Merrill Lynch continue to operate profitably and to compete effectively for market share with firms with commercial parent companies.[4] There is not any evidence that such affiliations in the banking industry, if accompanied by appropriate regulation and firewalls, would produce different results.

Paradoxically, our existing system already permits the combination of banking and commerce within the United States. Unfortunately, the combination is limited to U.S. banking and foreign commerce. Under the Federal Reserve Board's Regulation K, foreign banks that are part of commercial groups overseas are free to acquire U.S. banks.

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[4] In suggesting that the arbitrary barrier between banking and commerce should be lifted, the Commission is not suggesting that all financial firms should be part of larger commercial conglomerates. There is no empirical evidence that financial supermarkets are more inherently efficient than specialized financial firms.

For example, The Mitsubishi Bank, Limited owns three U.S. financial subsidiaries in California -- The Bank of California, N.A., Bank of California International Corp., and the Bank of California Capital Services and Consulting, Inc. -- as well as the Mitsubishi Bank Trust Company of New York. Although Japan abolished the large, concentrated holding companies, known as "zaibatsu," after World War II, many commercial and banking firms have maintained close but less formal affiliations within a looser structure of cross stock holdings and other relationships.[5] For instance, among the ten largest shareholders of The Mitsubishi Bank, Limited are Mitsubishi Heavy Industries, Ltd. and the Mitsubishi Corporation, as well as one other "Mitsubishi Group" company.

A partial list of the activities of the 29 companies in the "Mitsubishi Group" includes automobile manufacturing and sales, electronics, ship building, chemical plant construction and engineering, trading, warehousing, fertilizers, food production and distribution, textiles, lumber and pulp, tools and machinery, and insurance services. In effect, therefore, the Bank of California has indirect Japanese commercial relationships in these industries.

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[5] Such a group of related companies is sometimes referred to as a "keiretsu."

However, under the BHCA, a U.S. holding company with subsidiaries in these same industries is prohibited from owning a U.S. bank.[6]

This is not to suggest that the Japanese "keiretsu" system is a desirable model for the United States. It is important to note, however, that Japan, unlike Germany, does not permit universal banking. Instead, the Japanese system allows a full range of commercial and financial activities among related companies while maintaining a legal separation between a bank and any such affiliates. Thus, Japanese government authorities would be able to act to recapitalize or restructure a failing bank without necessarily becoming involved with any related companies engaged in the electronics or chemicals businesses.

Under the Japanese system banks have the advantage, moreover, of being able to obtain capital investment from any Japanese company. Given capital needs of U.S. banks, together with the fact that Japanese, German or other foreign banks with commercial affiliates such as Mitsubishi Heavy Industries can acquire U.S. banks, it seems odd that U.S. law would prevent General Electric, IBM or other U.S. commercial firms from similar investments in U.S. banks.

b. Consolidated Holding Company Regulation

Another unnecessary cost created by the BHCA in its present form is the requirement that the bank holding company must be supervised by the Federal Reserve, even if it does not supervise the principal operating companies. As a result, unless the BHCA is modified, an acquisition of a bank with only $10 million in assets by a securities firm with $30 billion in assets would subject the entire securities firm (together with its parent company and all affiliates) to consolidated regulation by the Federal Reserve. Accordingly, those securities firms that could acquire banks (i.e., those unaffiliated with commercial entities) would have to undergo a radical change in their regulatory supervision in order to do so. At a minimum this would result in significant new costs that would be avoided if the supervisor of the operating company with the largest capital were responsible for whatever holding company oversight or regulation was required.

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[6] The Mitsubishi structure is not that of a holding company with wholly-owned subsidiaries, as some have proposed to allow in the U.S. While independent of formal ownership by any entity representing the group, there are nonetheless business relationships between the companies of the Mitsubishi group.

2. The McFadden Act and the Douglas Amendment

While the countries of the EC are working to break down barriers to geographic expansion within the Community by 1992, the United States still imposes prohibitions on interstate branching (under the McFadden Act[7]) and interstate bank acquisitions (under the Douglas Amendment[8] to the BHCA). It will soon be possible for a German bank to open branches from Ireland to Greece, and from Denmark to Spain, operating largely under the supervision of German authorities. At the same time, it will remain unlawful for a California bank to open branches in Florida or Connecticut.[9]

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[7] 12 U.S.C. § 36(f).

[8] 12 U.S.C. § 1842(d).

3. State Securities and Insurance Laws

Other forms of state regulation create additional costs that could be reduced. State "blue sky" laws require that securities firms, even if registered with the Commission, register themselves and their registered representatives in each state in which they do business. Securities must be separately registered in each state in which they are offered. Although cooperative steps have reduced the impact of this system, differing registration requirements and operational standards continue to impose compliance costs on securities firms. U.S. issuers, and in particular small companies and mutual funds, also bear substantial costs in complying with both the federal disclosure requirements and the varying standards of the individual states.

State insurance regulation likewise results in multiple regulation of insurance companies, sometimes requiring insurance companies to establish separate subsidiaries in each state. Because of the state-by-state structure of insurance company regulation, insurance companies often engage in these activities through multiple subsidiaries owned through a multilevel holding company arrangement.

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[9] While most states have enacted regional banking compacts and a few permit nationwide interstate bank acquisitions, the McFadden Act still stands as a significant barrier to nationwide banking, and it imposes higher costs on engaging in interstate activities through multiple, separately incorporated banks within a holding company complex than would interstate branching.

4. The Exclusivity Clause of the Commodity Exchange Act

Finally, as I have discussed with this Committee before, the fragmented regulatory system governing trading in stocks, options and stock index futures, along with the exclusivity clause of the Commodity Exchange Act, creates serious costs that financial firms in other countries do not incur. These costs include the necessity of extensive litigation to determine whether innovative new products contain any element of "futurity," as well as the cost of conflicting compliance systems for firms that typically operate in stocks, options and index futures -- a single market which, unlike any other competing nation, has two different regulators.

II. A New Model for Financial Services Regulation

A new financial regulatory system should be designed as an integrated whole, in a manner that ensures that any proposed new statutory framework would be better than the current system, and that any steps taken will not have unintended side effects that would be more costly than the benefits of reform. That is not to say, however, that every element of the financial services regulatory system -- geographic and product limits for banks, deposit insurance, federal securities and commodities regulation, and state regulation of securities and insurance -- must be overhauled simultaneously. The EC 92 process demonstrates that far-reaching and fundamental reforms can be accomplished sequentially, yet still be achieved on an expedited and coordinated basis. Nevertheless, modernizing in fits and starts may prove costly. It would be far better to decide not only where we are going with financial services modernization, but also how we plan to get there.

In particular, new activities for banks should not be implemented without simultaneous consideration of reform of the deposit insurance system to reduce significantly the aggregate exposure of the taxpayers, to introduce market discipline, and to eliminate distortions in competition. Under current policies with respect to failures of large banks, the current extent of deposit insurance coverage, and the rapidly falling level of Federal Deposit Insurance Corporation reserves, it does not appear possible to be certain that significant losses by banks and their affiliates in new activities would be confined to shareholders rather than the federal budget or taxpayers. Therefore, it may be unwise to expand bank powers until we have also adopted reforms to assure ourselves that the risks of those activities will not be borne by the deposit insurance fund and the taxpayers.

With these concerns in mind, I will turn to proposals for a new regulatory scheme for the 1990s and beyond.

A. Universal Banking

One regulatory model that has been proposed is "universal banking," which is currently in effect in Germany and elsewhere in Europe.[10] This system would allow banks to engage directly in securities activities and thus permit credit risks from lending activities and market risks from securities and investment activities to be blended together within the bank. This prospect is attractive to some because it would encourage potential synergies among related financial service products and activities.

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[10] Under the universal banking system, banks can engage directly (rather than through subsidiaries or affiliates) in a broad range of financial activities, including securities trading and underwriting. In addition, universal banks are allowed to hold interests in, and exercise influence over, commercial enterprises.

However, the universal banking system would raise a number of serious concerns if transplanted to the United States. Specifically, if coupled with deposit insurance, a universal banking system could enormously increase the financial risks in a single institution whose losses would ultimately be guaranteed by U.S. taxpayers. In dollar terms, this means that the aggregate of $3.5 trillion in securities industry assets currently outstanding (and potentially the $1.7 trillion in insurance assets) could be added to the existing $3 trillion in assets held by insured banks, thereby vastly increasing the federal "safety net" for banks. Access to deposit insurance coverage also would serve to subsidize the risks of financial activities that are currently being more than adequately performed without public subsidies.

Furthermore, evidence indicates that a universal banking system could well adversely affect the depth and liquidity of the U.S. securities markets. While numerous factors play a role in the size of a nation's equity securities market, it may not be accidental that the two largest equity markets in the world are found in the U.S. and Japan, where universal banking is unlawful. In contrast, Germany, with a universal banking system, has an aggregate equity market capitalization that, as a percentage of its economic size, is approximately one-half that of the U.S. and one-third that of Japan [see Figure 8].[11] Because of the importance of the securities markets to the overall U.S. financial system, we should proceed with extreme caution before adopting an unfamiliar regulatory system that could impair the capital-raising process or the safety of the deposit insurance fund.

B. Simplified BHCA

The fundamental alternative to universal banking is to use holding company affiliates as the structure for diversification. However, unless the unnecessary restrictions and costs that are built into the existing BHCA are eliminated, the benefits of modernization could be greatly reduced or even completely offset.

There are several ways to simplify the BHCA. First, under a simplified BHCA, "overall" supervision of the holding company should be allocated to the federal agency with regulatory oversight over the financial services subsidiary with the largest capital investment. By keying off the deployment of the firm's risk capital, the selection of the holding company supervisor would parallel the firm's area of business concentration. A similar type of system was recommended by the Bush Task Group in 1984, with the concurrence of Federal Reserve Board Chairman Paul Volcker.[12] Consideration of a similar approach was recently suggested by E. Gerald Corrigan, President of the Federal Reserve Bank of New York, in testimony before this Committee.[13]

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[11] A recent study by the Centre for European Policy Studies suggests that the universal banking system has contributed to the smaller size, in terms of GDP, of the German securities markets. See A. Steinherr and C. Huveneers, Universal Banks: The Prototype of Successful Banks in the Integrated European Market? A View Inspired by German Experience.

Second, the functions of the holding company regulator should be streamlined to eliminate the preapproval process for adequately capitalized firms proposing to engage in new types of activities or to operate in new locations. Instead, the regulator should be charged with policing restrictions on interaffiliate transactions and activities and helping to coordinate examinations and other monitoring of the capital and other regulatory standards applicable to federally regulated operating affiliates in the holding company complex such as banks or broker-dealers.

Third, like bank holding companies today, financial services holding companies should be subject to the existing uniform disclosure and accounting standards for all public companies. Market discipline, based on uniform periodic disclosure of financial and other material results, is the longstanding and proven means for evaluating and controlling risks among publicly held commercial or industrial firms.[14]

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[12] The Bush Task Group determined that it would be most appropriate to allocate holding company oversight to the agency with the greatest familiarity with the overall company's operating activities. In particular, the Task Group recommended that, with some exceptions, oversight of bank holding companies should be conducted by the Federal Reserve or the Comptroller of the Currency, depending on which agency supervised the largest volume of the holding company's total banking activities.

[13] Testimony of E. Gerald Corrigan at 34-35, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs, 101st Cong., 2d Sess. (May 3, 1990).

Fourth, as is true today, the holding company regulator should continue to defer to any regulator of one of the holding company's subsidiaries. In particular, the holding company regulator should not have the authority to set the appropriate capital and other prudential standards for any affiliated bank, broker-dealer, or insurance company, as the case may be, or to otherwise restrict its closure or liquidation when deemed necessary in order to protect the public by the primary regulator of any such affiliate.

Each line regulator should be entitled to obtain information relating to material risks in the other affiliates in the holding company. In addition, each line regulator should be able to examine the holding company or its unregulated affiliates when it suspects unusual or fraudulent activity. This multiple investigative authority would prevent a serious problem from growing undetected.

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[14] In order to facilitate functional regulation, the obsolete exemptions in the securities laws for banks and bank securities activities should be eliminated. These include the exemptions from registration under the Securities Act of 1933 for securities issued by banks and thrifts (along with the related provisions of Section 12(i) of the Securities Exchange Act of 1934), the exclusions from the definitions of broker and dealer in the Exchange Act, and various provisions of the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Senator Wirth has introduced S. 2496, the "Bank Securities Registration and Administration Act of 1990," which would largely accomplish these results as they relate to securities registration and periodic reporting under the Securities Act and the Exchange Act. The Commission supports this bill.

C. The Subsidiary Oversight Model

The amendments suggested above would ameliorate the rigid regulatory structure inherent in the BHCA, reducing costs without reducing safety. However, while significant revisions to the BHCA are the minimum requirement for effective financial system reform, Congress should consider a more fundamental shift in the nature of bank holding company regulation, one in which there would not be a holding company regulator at all. Instead, there would be a system of regulation by each line regulator of its regulated entity in tandem with combined oversight of the condition of the overall entity by each line regulator. Such a system would build on the system currently in effect for such large holding companies as Sears, General Electric and American Express.

Under the "subsidiary oversight" model, a holding company would be free to pursue its chosen lines of business -- without preapprovals -- subject to the regulation of each of its financial services affiliates by the appropriate regulator. Each such regulator would be entitled to receive, on a regular basis, a "snapshot view" of the overall financial condition of the holding company and any material activities of its holding company parent and other affiliates. In addition to the information provided by such periodic reporting, the regulator would have the power to require the disclosure of inter-affiliate financial activities.

The primary job of each regulator would be to set capital levels and other policies limiting the use by a holding company of its subsidiary's net worth or credit (including the payment of dividends to, or the making of loans to, a parent company or another affiliate), and to monitor the holding company's condition. Each regulator would have residual authority to respond to financial instability in the holding company by taking immediate action to ensure that the regulated entity's capital is not impaired.

The effectiveness of the subsidiary oversight model would depend on, among other things, the existence of adequate capital in each regulated entity. In order to protect their public customers and the broader financial system, regulated financial entities such as banks and broker-dealers must be required to satisfy realistic capital requirements at all times. This capital provides a cushion in the event of financial difficulties, and it can enable regulators to take action before the capital is completely depleted and the deposit insurance or SIPC fund must step in to make up the difference. Under a "subsidiary oversight" model, then, capital would be a key element in protecting regulated financial services entities from the risks that their affiliates choose to accept.

In addition to the power to set proper capital standards, the regulator should have "early intervention" authority to step in instantaneously when a regulated entity's capital position is threatened or falls below the mandated level. If a regulated entity falls out of compliance with its capital requirement, it should be required to replenish its capital immediately. If the parent is unwilling or unable to do so, the regulator should be allowed to take steps such as sale of the company to another firm to protect the public interest. At all times, the line regulators should have authority to prevent the holding company from depleting the capital of the subsidiaries.

As the failure of Drexel Burnham Lambert Group Inc. ("Drexel") indicates, however, it will not be possible in many circumstances to avoid "contagion" within a combined firm. Even a well-capitalized regulated subsidiary may simply be unable to retain the necessary financing to continue long-term operations if its parent is in sufficiently serious trouble. Therefore, in the event of holding company problems, regulators should have the authority to take the same steps that they could take if the regulated subsidiary's capital is impaired. They must be able to require the subsidiary to liquidate and wind down its operations. These steps should be taken before the firm's capital is exhausted. Thus, even if the holding company's financial losses cannot be isolated from its regulated subsidiaries, those subsidiaries' operations can be transferred or shut down while they are still solvent.

The subsidiary oversight model assumes that the system must be designed so that the regulated banking, securities, or insurance entities can be "uncoupled" from the parent, like railroad cars uncoupled from a train. Any such subsidiary would then be dealt with as necessary to prevent (or minimize) harm to the financial system as a whole, the entity's customers, or the relevant insurance fund. If the required level of capital is sufficiently high, all of those steps can be taken without transferring any of the cost of the liquidation to the U.S. taxpayer or to the regulated entity's public customers, and without affecting the rest of the financial system.

The flexible regulatory approach posited by the "subsidiary oversight" model involves cooperation, coordination, and information-sharing among the regulatory agencies involved. Regulators of bank and broker-dealer affiliates would share information on a regular basis and coordinate their activities in the event of a crisis situation. This approach worked well in the government's monitoring of the collapse of Drexel. The Commission and the Federal Reserve Bank of New York (along with the Treasury Department and the Federal Reserve Board) were in constant contact, and each agency supervised the operations of its own regulated entity during the crisis. Drexel's failure ultimately did not cost the U.S. taxpayer a penny even though there was not a single "holding company" regulator.

The subsidiary oversight system also would make use of public disclosure as a regulatory tool. Thousands of public investors and industry analysts, each acting in their own self-interest, are far more likely to spot potential financial problems than a single regulator. To do so, however, it is essential that the information received by the public is complete, accurate, timely, and fully comparable to information available about other public companies.

Thus, a "subsidiary oversight" model, based generally on the securities mode of regulation, should enable U.S. financial services firms to reduce substantially their costs and to attract the capital needed to compete in the 1990s and beyond. Holding companies would be free to engage in their chosen lines of business, without prior approvals. Barriers to entry would be eliminated and commercial parents could provide new capital and management skills to regulated financial service entities, providing them with a source of competitive strength. Oversight of the holding company by specialized regulators would be more efficient and less intrusive than expansive substantive regulation by a single agency that may be unfamiliar with many areas of the holding company's operations.

However, this flexibility would not be achieved at public expense. Capital requirements for regulated financial entities would have to be tough, thereby imposing market discipline and a cushion of strength in the event of financial crisis. Full and comparable disclosure of the holding company's activities would be required to the public, as well as to the primary line regulators. Finally, the specialized regulator would be well-informed and poised to react immediately in order to take corrective action in times of financial instability.

D. Need for Firewalls

Regardless of which method of holding company regulation is utilized in forging an updated financial services regulatory system, so-called "firewalls" must be implemented to restrict the flow of funds and transactions among affiliated entities within the same holding company complex. While some have argued that firewalls inhibit the potential synergism of a financial services holding company and are not effective in insulating one affiliate of a holding company from "contagion" by another, the Commission believes that carefully tailored firewalls are an essential component of any new regulatory system.

Without firewalls, federally-insured institutions can pass along funding advantages to their affiliates and thus subsidize their risk-taking activities. The advantage of firewalls is that they help create and maintain a separate identity for affiliates within a holding company structure. A system that permits federally-insured banks to engage in new powers in the context of a holding company structure without firewalls would be tantamount to universal banking. This would represent a serious threat to the deposit insurance fund. Accordingly, from a public policy perspective, the Commission believes that is necessary to use firewalls around a federally insured banking entity to protect the federal insurance fund, and to prevent banks from passing on any possible funding advantages to their affiliates.

While it is true that firewalls cannot prevent registered subsidiaries from ultimately experiencing liquidity and financing problems as a result of a holding company failure, that fact does not negate the important role firewalls may have in slowing contagion and facilitating the sale or liquidation of specific subsidiaries before losses result for public customers. Firewalls can prevent the regulated entities from being stripped of capital or liquidity reserves to prop up a failed parent, thus ensuring that the regulated entities do not suffer traumatic losses simultaneously with the failure of the holding company. Maintaining the capital of the regulated entities intact provides their regulators greater time and flexibility to manage failure in periods of holding company instability.

Thus, the key importance of firewalls and similar restrictions against upstreaming capital or liquidity to a parent is not that they will *prevent* failure from occurring, but rather that they will permit regulators to *manage* failure. Likewise, firewalls assist in creating separate identities for entities within a holding company complex, keeping creditors of affiliates separate, and permitting them to be dealt with separately in the event of liquidation or bankruptcy of the holding company.

Despite the absolute need for appropriate firewalls in any new system, the Commission is sympathetic to the position that not every restriction labeled a firewall may be constructive. Taken to the extreme, firewalls may destroy some of the competitive opportunities and economic advantages to banking organizations that would arise as a result of their diversification. One way to ensure that firewalls are not over-broad is to provide each line regulatory agency with authority to implement and enforce a set of firewalls between the entity it regulates and such entity's affiliates. This would allow each agency the flexibility to adjust its requirements as necessary and eliminate any rigidities resulting from the imposition of firewalls by statute.

III. USA 1992

In discussing these proposals for reforming the U.S. financial system, Congress should review the full range of impediments on the effective operation of our financial institutions to eliminate those restrictions that no longer serve a valuable function.

We have an example for this review in the EC 1992 program. As part of its creation of a truly common European market in products and services, the EC is committed to eliminating cross-border restrictions on the operation of financial institutions, the issuance of securities, and the operation of the securities markets. The EC also is using this opportunity to reshape the content of financial regulation, such as in establishing the permissible structures for financial institutions. The EC is requiring all its members to modernize their financial regulation to reflect its policy choices, and to facilitate the Community-wide market. Above all, the EC is eliminating arbitrary barriers to competition.

The EC countries are putting aside their differences. Together they are creating a unified market designed for the lowest feasible operating costs. The new EC financial system envisions a single market for a combined population of 325 million people with a combined GNP of over $4 trillion. This market will have the liquidity and the efficiency to represent a serious competitive challenge to both the U.S. and Japan.

Here at home we can watch the erosion of U.S. market share, or we can decide to respond by clearing our own decks for competitive action. A "USA 92" initiative could easily involve a reexamination of our own domestic markets as sweeping as that being carried out in the European Community today. We need to retain those legal structures that create safe financial markets that protect investors and foster U.S. competitiveness. At the same time, we could jettison the extra freight accumulated over decades that no longer serves those purposes. As noted above, such a program should be comprehensive in scope, and carefully thought out. It should be worked out in a bipartisan fashion between the Administration and Congress, and in full partnership with the states. Any change must make our markets more efficient without weakening stability, artificially distorting competition through public subsidies, or incurring greater risk to the integrity of the market or the U.S. taxpayer. Reform of the Glass-Steagall Act and the BHCA should be the cornerstone of a reexamination of the U.S. regulatory system, but these actions are not enough. The Congress should also consider the full range of domestic geographic impediments, barriers to product competition and reform of deposit insurance.

IV. Conclusion

This nation's capital markets are a vital economic asset. They are a substantial source of jobs and earnings, and they are vital to the competitiveness of firms that utilize the capital markets to raise funds for new plant, equipment, research or other investment. The $3.5 trillion equity securities market in particular is the "crown jewel" of the overall U.S. financial system. It is the repository of investment capital accumulated over more than two centuries, and it is the storehouse of funds from which we must create tomorrow's prosperity and economic growth.

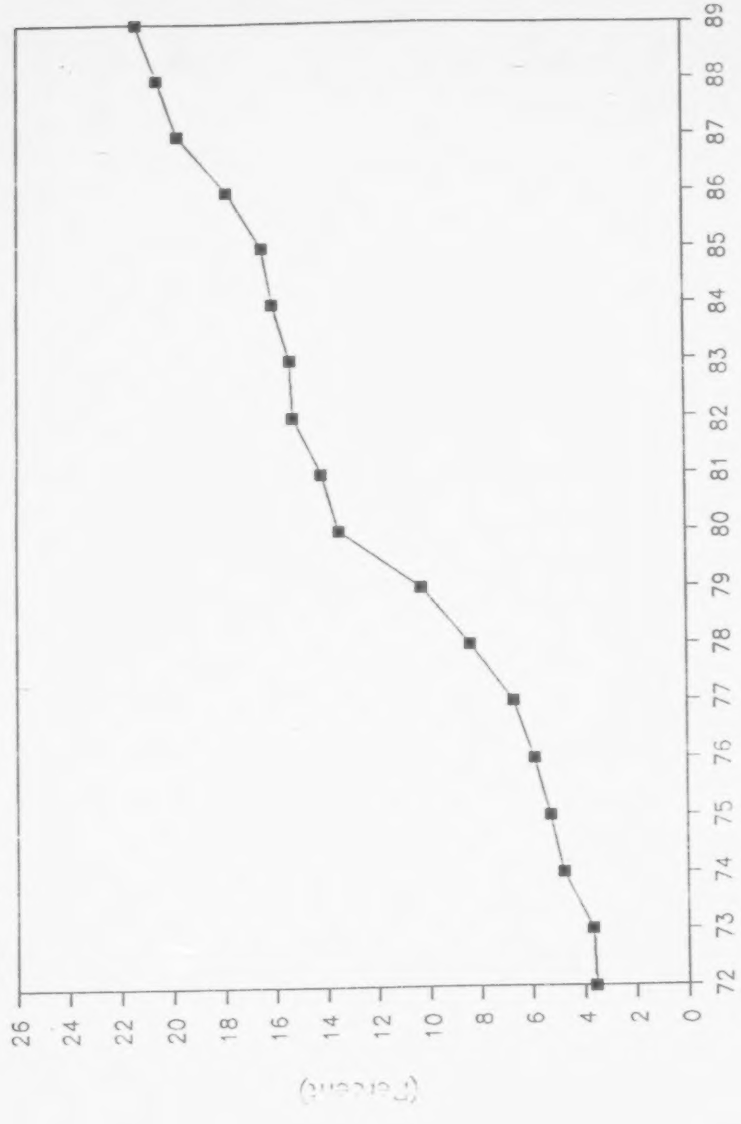
Modernization of our regulatory structure is an important objective. Interstate branching restrictions; blue sky requirements; the exclusivity clause of the Commodity Exchange Act; and artificial separation of banking and U.S. commercial firms, banking and insurance, and banking and securities under the BHCA and Glass-Steagall Act all create some degree of avoidable regulatory costs, or reduce the liquidity and efficiency of U.S. financial firms and markets. Where unnecessary overhead costs can be eliminated without harm to the safety or stability of the system, then we should be prepared to act. Our competitors in Japan and Europe are taking similar actions designed to lower costs of capital, reduce inefficiencies, and improve liquidity, and the U.S. should not ignore the competitive challenge we face.

At the same time, not all change would be productive. Securities, banking, and insurance have very different traditions and means of conducting business. Intermingling ownership will not guarantee improved earnings. Indeed, in many cases expansion into unfamiliar lines of business will produce serious losses. Firms that have strong balance sheets and strong earnings and that do not have taxpayer underwriting of their losses should be free to experiment and to compete in a free market. However, even strong firms should not be allowed to expand into new areas of finance if the result is that U.S. taxpayers will be forced directly or indirectly to bear greater risks of loss or to bear greater budgetary costs of subsidizing firms -- through the deposit insurance system, bailouts, or otherwise.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") represented important action by Congress and the Administration to require sound capital rules, accounting principles, and other prudential standards for the S&Ls. FIRREA eliminated the short term risk of a sudden collapse of the entire S&L industry, which would have had ruinous consequences for tens of millions of depositors and for the U.S. economy at large. However, the task of reforming and limiting deposit insurance has not yet been undertaken, and it must have a very high priority. At the same time, we should be prepared to reduce unnecessary competitive barriers in a carefully thought out process that at all times must satisfy the ultimate test that any change must make our markets more efficient without weakening stability or artificially distorting competition through public subsidies or incurring greater risk to the integrity of the market or to the U.S. taxpayer.

It would be all too easy to find excuses why modernization should never occur. However, we must also recognize that the financial services industries of the U.S. face intense foreign competition from firms that may have significantly greater flexibility in their systems of oversight. Therefore, it is imperative that we work together to design a sensible and prudent means of comprehensibly modernizing the U.S. system to keep our firms and markets strong, safe, profitable, and successful in an intensely competitive international market.

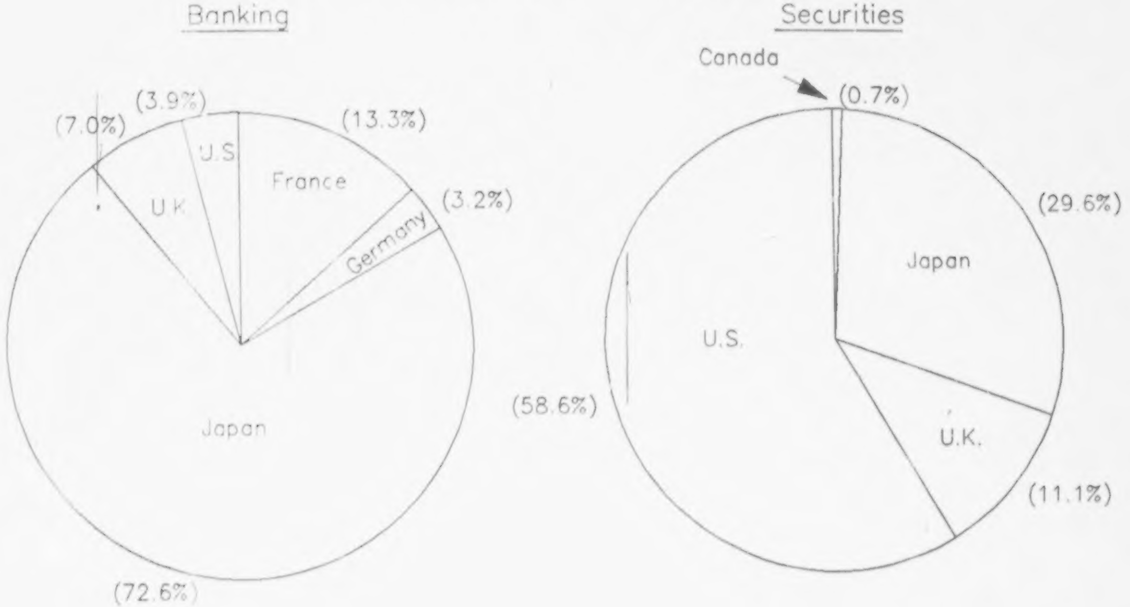
Foreign Ownership of Domestic Banking Assets, 1972–1989



Source: Board of Governors of the Federal Reserve System

FIGURE 1

Asset Shares of World's 25 Largest Banks and Securities Firms
By Home Country of Firm, 1988


Banking

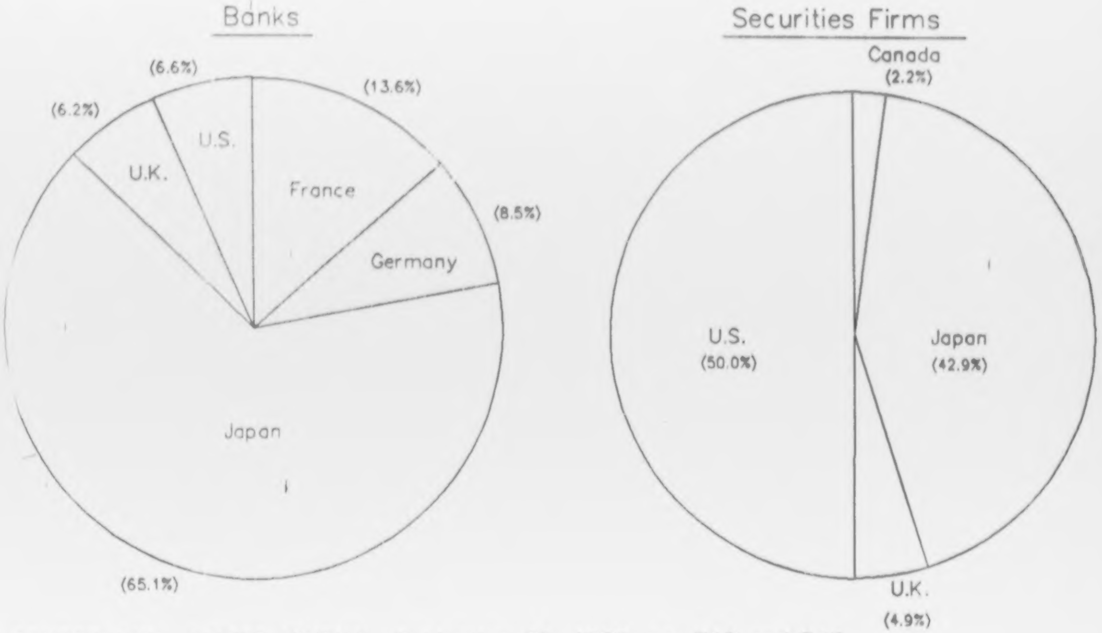
Securities

OURCE: WALL STREET JOURNAL, September 22, 1989, pp. R16 and R18.

FIGURE 2

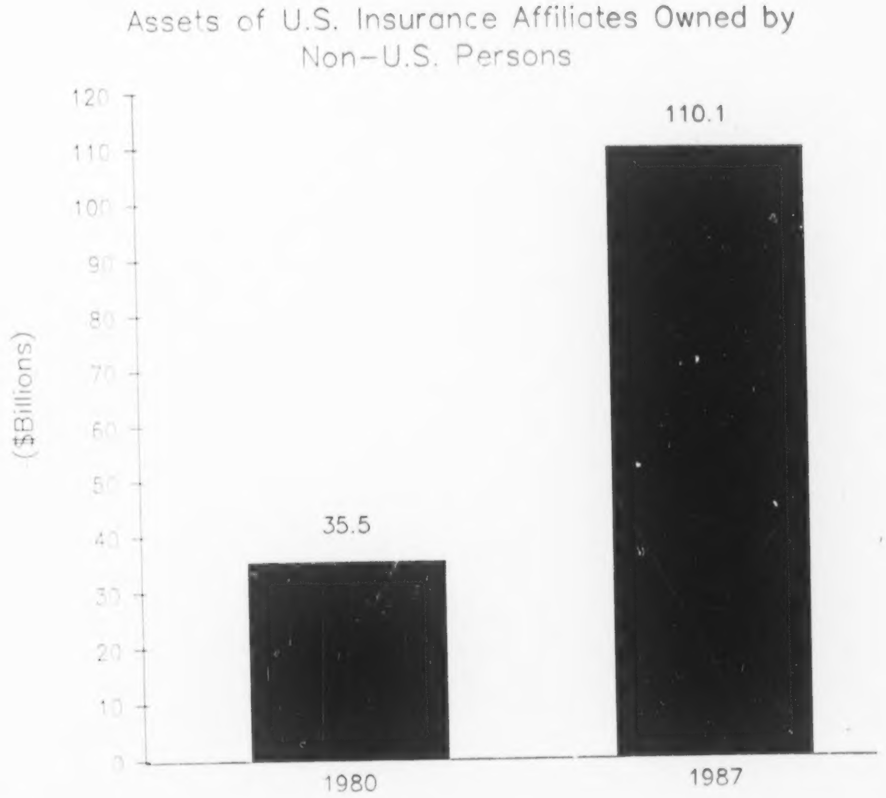
Capital Shares of World's 25 Largest Banks and Securities Firms

By Home Country of Firm, At Year-end 1988



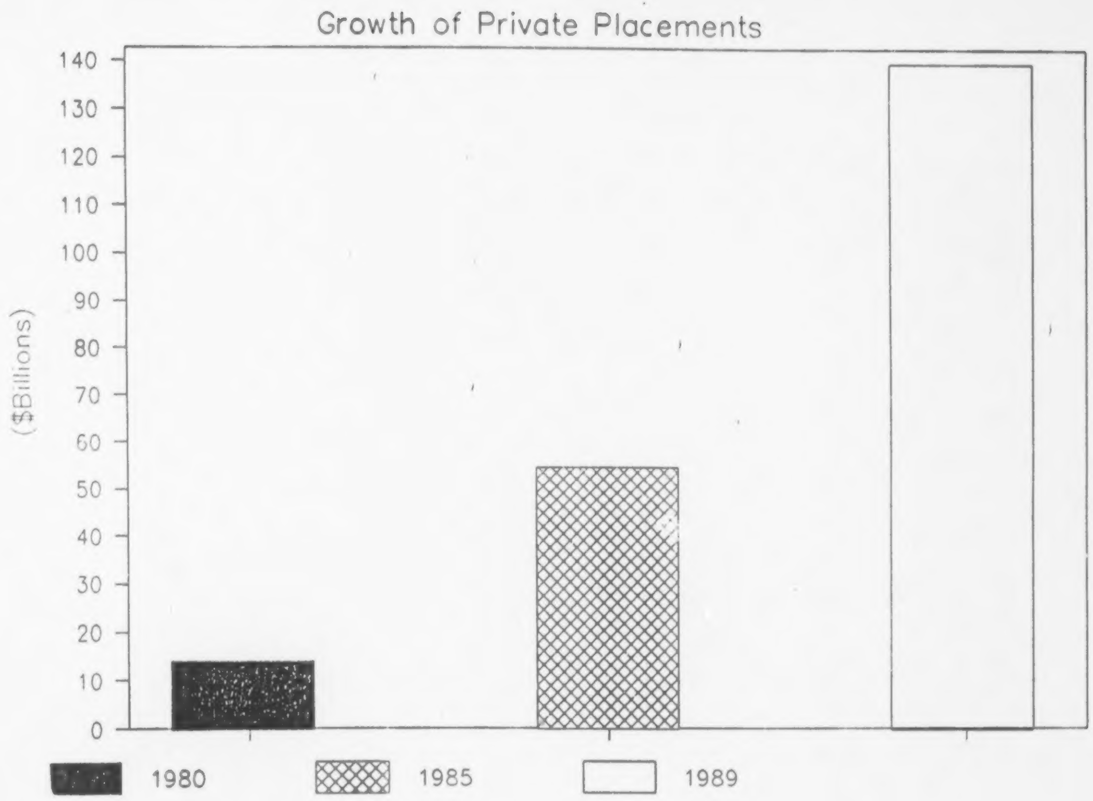
SOURCE: WALL STREET JOURNAL, September 22, 1989, pp. R16 and R18.

FIGURE 3



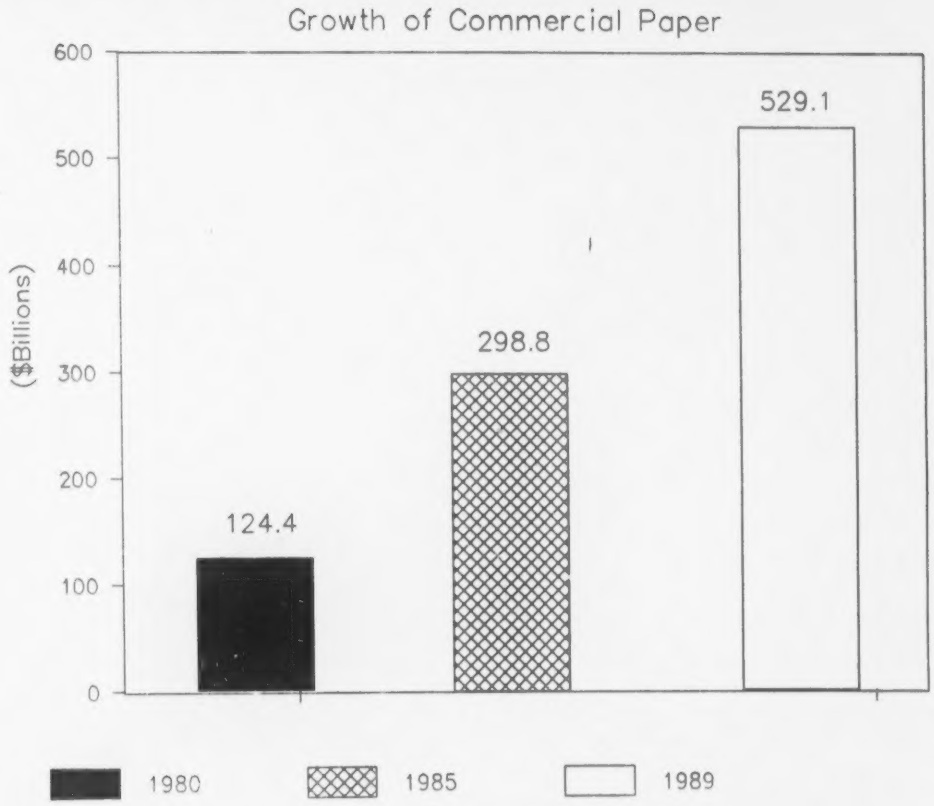
Source: U.S. Department of Commerce

FIGURE 4



Source: IDD Information Services

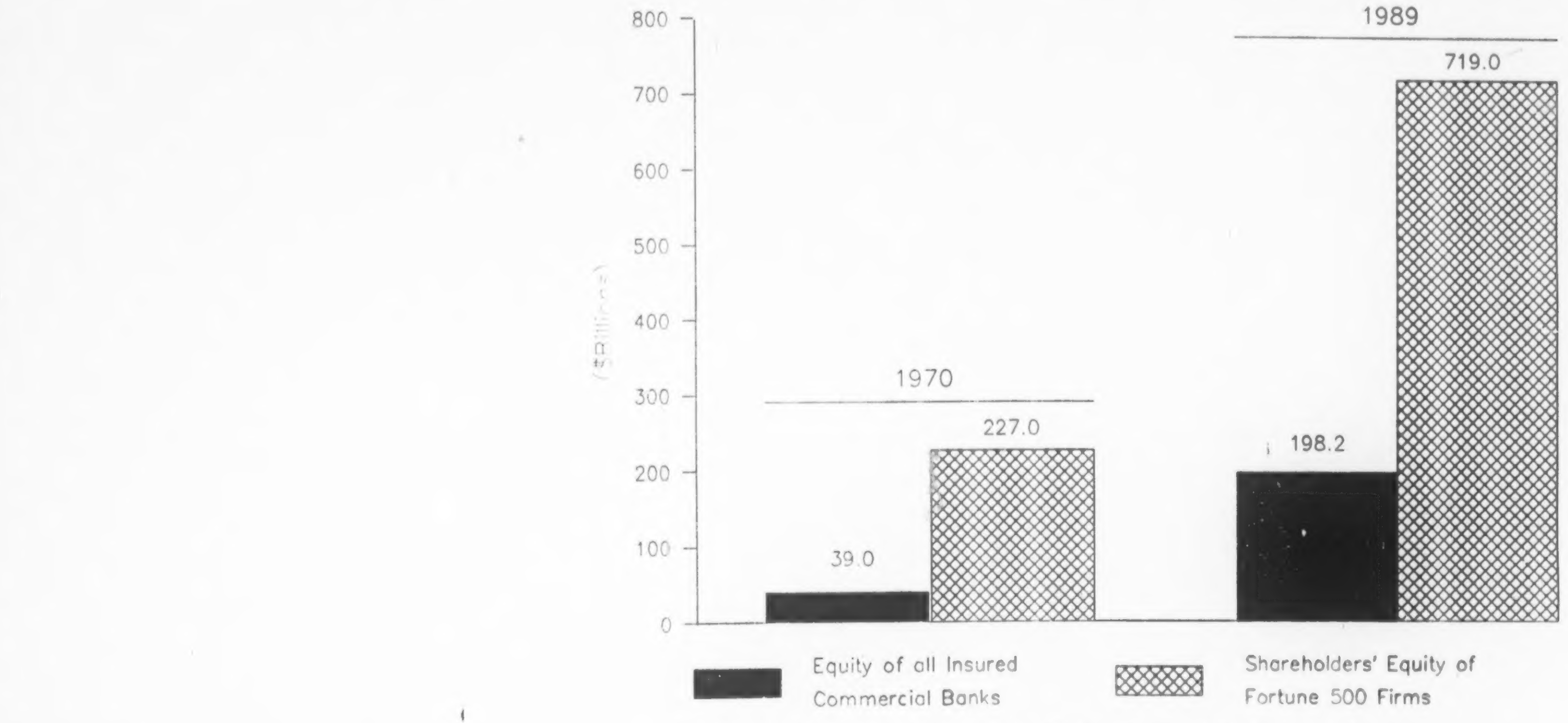
FIGURE 5



Source: Board of Governors of the Federal Reserve System

FIGURE 6

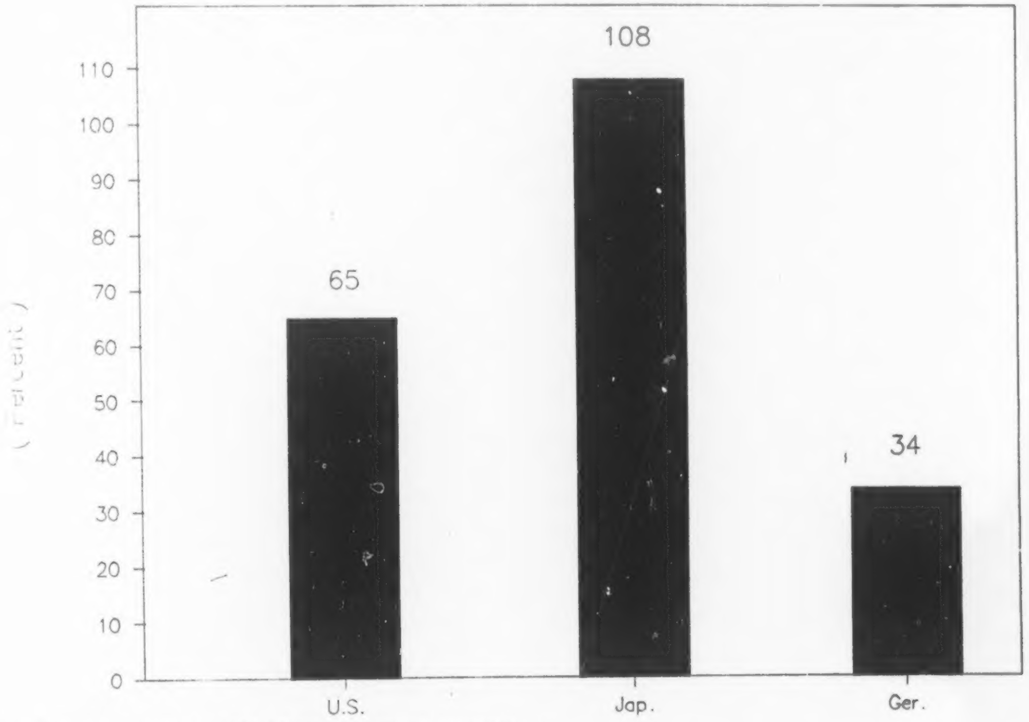
Equity Capital of Banks and Fortune 500 Firms Compared, 1970 and 1989



Source: Board of Governors of the Federal Reserve System and Fortune

FIGURE 7

Market Capitalization as a % of GDP, March 31 1990
U.S., Japan, and Germany



SOURCE: ESTIMATED BY OFFICE OF ECONOMIC ANALYSIS
USING DATA FROM IFC, OECD AND GOLDMAN, SACHS

FIGURE 8

The **Chairman**. Thank you very much, Chairman Breeden.

Senator Shelby has come in and did not have a chance to make an opening comment.

Senator **Shelby**. Mr. Chairman, I just have a written statement that I would ask to be made part of the record, and I will await my turn.

The **Chairman**. Very good. We will make Senator Shelby's statement a part of the record as well as Senators Dixon and Sanford.

STATEMENT BY SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, let me commend you for scheduling this morning's hearing. This series of hearings on financial modernization has been excellent thus far and today's witness I am sure will continue this trend.

Richard, let me welcome you here today. We appreciate your taking the time to share your views.

Financial modernization is not a new issue for you; you have been a key player in this debate before and we look forward to benefiting from the knowledge that you bring to the table on this subject.

Back in 1988, this committee worked hard to put together a bill that would have allowed for a significant reshaping of the financial services industry. The Senate passed it. But the House failed to cooperate and today we find ourselves back at the drawing board.

In the intervening 2 years, however, the marketplace has not been standing still; de facto deregulation modernization is taking place while Congress fails to act. The Fed is permitting expanded equities underwriting activities for U.S. banks abroad; the States are authorizing insurance underwriting.

The conventional wisdom says that the dynamics of the marketplace have gone beyond the legislation that this committee passed in 1988. And yet, the ever increasing cost of the savings and loan bailout, that is a direct result of ill-conceived, haphazardly administered deregulation dictates that when Congress acts, and thus has the opportunity to err, that it errs on the side of caution.

I am not opposed to financial modernization. In fact, with the competitive pressures in the financial services industry continuing to change, I would say that by not acting Congress is making the mistake. The scattershot method of deregulation that is currently taking place through regulatory decisions, court interpretations, and State legislatures poses more risk to the deposit insurance system than a carefully conceived, comprehensive legislative approach.

It is my understanding that you favor a system of functional regulation, where the appropriate regulatory agency regulates each respective sub within a holding company. In principle, this approach makes sense, particularly with respect to the integration of traditional banking and securities activities. However, I think this becomes more difficult when you consider a financial institution owned by or related to a commercial concern. I personally object to banks being in the insurance and real estate businesses. I am interested in your view on how we confront that problem.

Of course, we must limit the exposure to the deposit insurance fund before we do anything else. Last week, Chairman Greenspan testified that strong capital reserves would be the best cushion between the insured institution and the taxpayer. I would be interested in your view on that, as well as any comments you may have on a risk-based deposit insurance system.

We appreciate your being here and look forward to your testimony.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. President, we are here today to continue our hearings on modernizing the regulation of financial services. It is absolutely beyond dispute that such modernization is long overdue.

We have heard from the distinguished Chairman of the Federal Reserve Board, Alan Greenspan, and the distinguished president of the New York Fed, Jerry Corrigan. Based on their testimony, and the testimony of many of the other witnesses we have heard, it is clear that our statutory framework for regulating our banks is out of date and that substantial structural reform is needed.

The cornerstone of our modernization effort must be deposit insurance reform. When our system of regulatory "safety nets" was put into place, banking was a protected business, one that was at least somewhat immune to economic shocks. Indeed, between the 1940's and the late 1970's, only approximately seven banks a year failed. Banking has lost its immunity, however. The marketplace has now effectively "deregulated" banking, and our safety net must be fundamentally reformed to reflect that fact.

The risk-based premium proposal I will introduce later this year will provide the essential kind of market discipline that is so badly needed. It will also ensure that banks raise more capital, something that Chairman Greenspan made clear is much needed.

We should not lose sight of the fact, however, that we also need to act on expanding bank asset powers, for both domestic and international competitive reasons. Both Jerry Corrigan and Alan Greenspan had sound recommendations to make in that area. I know my own bill, the Proxmire Financial Modernization Act that passed so overwhelmingly in 1988, is now out of date, and needs to be adjusted to reflect current realities. I plan on making a number of changes in that bill over the fall, and on reintroducing an updated bill early next year. I look forward to working with my colleagues on this committee and with all interested parties, in a bipartisan effort to see that we make sound reforms in our safety net and in the powers area as quickly as possible in the next Congress.

I therefore want to take this opportunity to congratulate the chairman for holding this series of hearings this year. Because of his leadership and initiative, this committee will be in a position to take prompt action next year.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. First, let me say once again how much I thank you for putting together this important series of hearings on the modernization of the financial services industry. As we settle into the 1990's—a decade which will see great change in Europe and throughout the world—it is important that our banking system maintain its competitive position in the global market. If we are to remain a world power, it is vital that our financial institutions keep up with the rapidly expanding financial sectors in the European Community and Japan.

In the coming months, the Banking Committee and the full Senate will be called upon to provide our financial institutions with the tools they need to survive and prosper in this increasingly global banking community. We must remember throughout, however, that American Banks, Savings and Loan Institutions, and credit unions also have a duty to serve the small towns and communities across our nation—modernization must not sacrifice the average citizen who depends on secure, high-quality banking services. The careful balance required to ensure our entire banking industry a healthy future will require our utmost attention.

Chairman Breeden, let me thank you for taking the time to share your thoughts on banking reform with this committee. The continued soundness of our financial services industry is such an expansive topic that it is important for us to hear from as many expert witnesses as possible. I am certain that your insight into the problems facing our financial institutions, and any possible solutions you might offer, will be of great help to all of us as we begin to consider options for reform.

I am particularly interested in your suggestions on deposit insurance reform. While the Savings and Loan crisis currently facing Americans points to some fundamental problems with our financial services industry in general, it seems that reform of the deposit insurance system would play a key role in avoiding any such failures in the future. While broad, far-reaching reform must be considered, the substantial taxpayer liability inherent in Federal deposit insurance merits a thorough examination.

I look forward to your testimony and to hearing your answers to the questions I am sure the members will have.

Thank you, Mr. Chairman.

The CHAIRMAN. Chairman Breeden, on this deposit insurance fund issue, we are obviously really focused on the question of how we deal with that and keep it secure in the future, especially after the S&L experience. In the context of any further financial deregulation, it might bring with it a change in the risk profile that would work its way back down to the deposit insurance guarantees with the taxpayer having to stand behind that.

I want to focus initially on the specific question of whether or not in any revised regime we should allow Federal deposit insurance to stretch out and protect State-created authorities and activities. We have had a dual banking system in the country for a long time in the S&L area and in commercial banking where, as you know, we have had Federal standards; but then the States have been allowed to go beyond that in certain ways. And yet those State-chartered activities were directly connected back to Federal deposit insurance.

Now you probably had as much to do with drafting the overarching strategy and architecture of the savings and loan recovery plan as anybody in the Government. I mean, you have been involved in this over a long period of time. So this is something that you have had some occasion to work with and think about.

I want to give you some data here, and then I want you to react to it. You might want to write it down. There will not be much of it here.

I am going to start with the years 1987 and go through 1987, 1988, 1989, and January through April 1990. We have gotten from the Resolution Trust Corporation the cost of thrift resolutions represented by the failures of State-chartered thrifts. If you take all 50 States—I am going to give you two columns—all States, and then just the States of Texas and California.

What they have determined is that in the year 1987, 66 percent of all of the losses in the savings and loan system occurred within State-chartered thrifts. In 1988, that figure went up to 75 percent. In 1989, it went up to 92 percent. So far in 1990, January through April, the figure is 59 percent, but we are told that is low and they will be adjusting that number upward. So if you take an average over this entire period of 1987 through April 1990, 73 percent of all the savings and loan losses occurred in State-chartered thrifts throughout the country.

But if you go over to the next column which would just be Texas and California, to give you an idea as to how heavily concentrated this was, in 1987 the figure, 54 percent of the national losses were in State-chartered thrifts in just those two States, Texas and California.

That jumped up in 1988 to 70 percent. In 1989, 62 percent, and so far in 1990 through April the figure is 57, again subject to an upward revision. So the running average over the time period is 67 percent of all the national losses occurred in State-chartered institutions in just those two States.

Now I want to give you one other number, just to give you an interesting cross-reference to the meaning of those statistics. I asked the RTC on June 12, of all the assets that are in the junk pile, all of the repossessed assets of golf courses, and marinas, and wind-mill farms, and whatever else they have in there, commercial properties and what have you, first of all what was the value of all of the assets that are in their possession at the present time? And where those assets are.

It turns out that of the total book value of the assets in the hands of the RTC due to these repossessions from failed thrifts, 69 percent of all of the asset value is represented by assets that exist within the boundary lines of the State of Texas. 69 percent.

Now you do not have to be a genius to think about the fact that if you could subtract that part of the problem out of the problem, you have an entirely different problem to have to look at. I think there is a very significant cross-connection between the magnitude of the massive percentage of the losses accounted for by State-chartered thrifts, where these assets are that have been repossessed in terms of just their physical geography which is a cross-check and another way to measure the same problem.

My question to you is: As we go down the track here, should we be putting Federal deposit insurance under activities that States want to authorize? Or has not the time come to absolutely, once and for all, put a stop to that? If we are going to have Federal deposit insurance, have it be only for federally authorized activities, federally regulated and supervised activities, and nothing more?

Chairman **Breeden**. Well, Senator, this is certainly an excellent question, and it is a serious matter. There is no question that there have been cases—and you referred to some of them—in which State regulation may have permitted more risky activities and may have not provided a comparable level of supervision, capital requirements, or other standards, and losses may have been the result.

On the other hand, it is not only conceptually possible, but we have seen it time and time again, where States have in fact removed what might be seen to be unnecessary competitive barriers that the Congress has allowed to exist at the Federal level. I think of the action of the New England States to allow the payment of interest on checking accounts. The New England States created the NOW account several years before Congress, after having a chance then to watch that experiment, found out that it was good for consumers and did not cause any particular problem.

Congress then extended that system that had been pioneered in the New England States nationwide. So I think——

The **Chairman**. Let me just stop you there. Then why, if we want to preserve the innovation aspect and not get into a situation where State-granted authorities can capsize the whole national system, which I think happened in the case of the S&L situation, why should we not then require that if a State wants to experiment that they seek approval to do so, that it be granted, that there be a test period, that you not just willy nilly go down the road and allow States to stretch out and do whatever they want on the strength of Federal deposit insurance. In fact, they could not have done it if they had not had Federal deposit insurance because they could not have gotten all of the brokered deposits to lever themselves up to the huge size that they did.

So can we not capture that and keep those experiments on a very narrowly limited basis and test them out, so that we fence off the risk to the deposit system? Why should we set the taxpayer up for another $½ trillion over 30, 35 or 40 years, for even some people now say as much as a trillion dollar loss? Why should we put ourselves in that kind of a risk profile?

Chairman **Breeden**. Well I agree that we should not put ourselves in that risk profile. We should take active steps to reduce the risk to the taxpayers of the Federal Deposit Insurance System, notwithstanding the fact that in these cases there was a substantial volume of losses from those particular states, and from many State-chartered institutions.

If you looked at the total assets nationwide of the S&L industry—I do not know the number off the top of my head—Texas and California probably represent a very high percentage of total national S&L assets. Therefore, they also represented a very high percentage of losses.

The **Chairman**. Yes. But if I may just say, if you scale back the State-chartered authorities to what the federally chartered authorities were that were available, you would have had much smaller industries I think in those two States. I mean, they would not have been able to grow to that size.

Chairman **Breeden**. Well, regrettably I think they would have been able to grow to that size as long as the Federal Home Loan Bank Board had in place a system of accounting that allowed people to count their accumulated losses as capital, and then leverage it 33 to 1. As long as that kind of an accounting system—which was in effect for both Federal and State-chartered thrifts—was in effect, they could have had a Federal charter and also grown in terms of asset size.

Now they might have been unable to put those assets in some types of activities, but frankly I am very concerned that we not always assume that having a narrower focus of permissible activities makes a safer system. I happen to be a believer in diversification, that that can be very, very healthy.

I would not want us——

The **Chairman**. But should we not do that on a national footing? If we are going to have a national insurance scheme and a national obligation to pay, should we not define the ground rules?

Chairman **Breeden**. I think absolutely that the entity providing the insurance has not only the right, but also the duty, to limit the risks that anybody that is going to be insured may undertake. While the States may choose to authorize a bank to run a casino, I think it should be the prerogative of the FDIC to decline to insure it. The FDIC should also have the authority to say that activities that go beyond what are allowed for Federal institutions, and which they believe are unduly risky at a minimum, have to be conducted in a holding company subsidiary somewhere that is not under the deposit insurance umbrella.

I agree with you completely in that respect. I am just not prepared to say that anything a State allows is automatically more risky than that which Federal authorities may allow. There have been cases in which the States have, in fact, allowed very positive products.

The **Chairman**. Well, I am over my time.

Senator Garn?

Senator **Garn**. Thank you, Mr. Chairman.

Let me just follow up on this point and summarize it. I do not think there is much disagreement. It may sound like there is. Richard, I do not think anybody wants to stifle State innovation, because there have been a lot of good things that have come from it. You mentioned the NOW account experiment in the New England States. There is no doubt about that. That is not really what we are talking about.

When Bill Proxmire was chairman, and when I was chairman of this committee, both of us were very much in favor States' rights. I still am. I think a State legislature ought to be able to do anything they want. If they want to let their S&L banks be in mushroom farms, Wyoming Downs Race Track, whether I think that is stupid or not, they ought to be able to do that.

The issue simply with me is: Should they have Federal insurance if they go beyond Federal guidelines? And I think the answer is clearly, no. Because if that had been the case, and either Prox or I had been listened to and that had been passed, we would not be discussing an S&L crisis today. There would be a hell of a problem in the States, but I am not a member of the Texas State Legislature.

I think there is the clear distinction. Fine. Let them innovate. Let them experiment. Let them do what they want as elected State representatives, but not with a Federal guarantee, either FSLIC at the time, or FDIC. I think that ought to be very, very clear. They should not be allowed to experiment at the expense of the Federal funds—and particularly when you look at those statistics: 73 percent of all the dollar volume losses occurring in State chartered thrifts? I think that makes the point very well, although often Federal deregulation is blamed. That is a myth that continues to be repeated over and over and over again in the press which simply is not factual.

No matter how many times it is printed, it is not factual. As an example, I am sure you are very well aware that since the 1970's Federal law allowed 2 or 3 percent of direct investments by S&L's. The Texas legislature allowed 40 direct investments in real estate, rather than loans of depositors money, which are a major source of these losses in these States; and California allowed 100 percent.

No Federal institutions are in trouble if they lose their whole direct investment portfolio with 3 percent of their assets. No institution is going to fail by losing 3 percent. But an institution in Texas and California, with direct involvement at 40 and 100 percent, will. So if people would look into the facts, what the Chairman is talking about is not a matter of his opinion or mine or yours. The facts of where the losses occurred and why they occurred are basically because Federal insurance was covering these activities created by State legislatures. That is not right, and that should not be allowed to be done by the States no matter how much I may believe in States' rights—and I still do. I do not like the Fed dictating.

So let them do their mushroom farms, but not with Federal insurance. Well, I do not want to use all my question time, because I want to get to the source of your testimony.

You indicate that firewalls are a necessary component of any new regulatory system. Last week, in testimony before the committee, Chairman Greenspan offered a somewhat different view in questioning the effectiveness of firewalls, and noting that they tend to reduce synergies and raise costs for financial institutions.

He indicated that recent events, referring to Drexel, have raised serious questions about the ability of firewalls to insulate one unit of a holding company from funding the problems of another. He suggests the kind of conflict of interest restrictions in section 23 (A) and (B) of the Federal Reserve Act are more appropriate.

How do you feel about his comments? What is your reaction?

Chairman **Breeden**. Well I certainly agree that 23(A) and 23(B) are very useful standards, and I think there would be broad consensus that those should be part of whatever package of firewalls exist. I have read Chairman Greenspan's testimony, and I think it is not easy to tell from the testimony. He has indicated there ought to be some firewalls, but maybe not everything called a "firewall" may be absolutely necessary. I would agree with that statement, also. The question really is what kinds of firewalls ought to be enacted.

I disagree with the proposition that we do not need to have firewalls if we are not certain that firewalls will prevent a failure. If you have a broker-dealer with $100 million in positive capital and it is affiliated with a holding company that loses $40 billion, eventually that subsidiary is going to be impacted. It will ultimately fail when the parent firm goes into bankruptcy and is liquidated.

There will be a market impact on that subsidiary. But the fact that a failure will ultimately occur does not mean that, in the meantime, the firewalls are irrelevant and that they are not in fact critical. The firewalls prevent the problems of the securities affiliate from spreading to a bank affiliate, or since banks tend to fail a little more often than securities firms, the problems in a banking subsidiary that is failing from spreading to a securities firm.

It is important to keep an ability to distinguish between the entities. They should not be so intertwined that the regulator of a bank cannot take that bank out and sell it to another bank before the holding company finishes collapsing, or that the securities regulator cannot take a securities firm out of the holding company and merge it with another securities firm.

I think firewalls are terribly important, even though they will not guarantee that firms ultimately will not fail.

Senator GARN. Well I would agree with you because there are a lot of laws—I guess you could relate it to traffic laws. We do not not have speed limits because some people violate them.

Chairman BREEDEN. Exactly.

Senator GARN. They still do provide safety for most of us. And as I am sure you are aware, in all of the bills I have sponsored over the years, firewalls have always been a part of that to the point of, in the 1984 act, and also in 1986, not only were they separate affiliates as opposed to separate subsidiaries to provide more protections, they were not even allowed to use the name of the parent institution so that people were not thinking, well, we have the full backing of the parent institution. And there is a lot of objection to that. But I do agree with your answer that firewalls are necessary even though they are not a guarantee of total success.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Shelby.

Senator SHELBY. Richard, I think it is instructive to us, and you are making this point well, that perhaps we have learned something from the hit on the deposit fund and ultimately the hit on the taxpayer.

I agree with your basic premise that, as we move into granting powers that a lot of the banks do not have, other financial powers, that we are going to have to do something first with the deposit insurance fund. And what is that? Is that limiting the size of the insurance? Is it bringing it down from the 100 to 40? Is it building sufficient firewalls? Is it some of both, or what?

Do you have some other suggestions, especially dealing with the size of the fund, of the insurance?

Chairman BREEDEN. Well, Senator, obviously with the caveat that since we do not have deposit insurance, happily, in the securities industry with the same kind of taxpayer backing that exists in the banking industry——

Senator SHELBY. But you have some background in this, as we all know, in helping resolve that other problem.

Chairman BREEDEN. Well I have thought once or twice about these problems in the past. But I would just put the caveat that these are my personal observations regarding deposit insurance and that I am not speaking on behalf of the Commission. This is not a problem that the Commission normally administers.

I think that we have too much deposit insurance in this country. We have more than $3 trillion in assets that are ultimately backed by the taxpayers. I think asking the taxpayers to underwrite the possibility of loss in every loan decision made by every lending officer in America is something that we could cut back on. I do not take as the starting point, although many people focus on this, coverage at $100,000 per account, or how much per account. I would prefer to start with: what is the overall size of the program? $3 trillion. Deposit insurance is a valuable program and serves useful purposes and is important to many ordinary depositors to maintain the safety of their deposits. I think we would all agree that there ought to be some amount of deposit insurance, but the question is, how much is enough?

Do we really need $3 trillion in deposit insurance? Or could we get by with a mere $1 trillion in the aggregate? Perhaps something less? I think by almost any standard the growth in the volume of insured deposits has been too great.

If you concluded that we wanted to set a cap, if we wanted to say let us shoot for a target of $500 billion in insured deposits, or $1 trillion, or $1.5 trillion, or pick some aggregate volume, then there are several ways to reduce the aggregate amount of insurance to get yourself down toward that cap.

One way is to limit the amount of insurance per account. Another is to limit the number of accounts that someone can have. It is today possible to have not only $100,000 per account, but a family of four can have eight accounts in a single bank, and they can have eight accounts in each of the 14,000 banks in America. So we could limit the amount per account and the numbers of accounts.

Or we could follow a different approach, which I happen to think is worth at least some consideration. That is, to let individuals decide for themselves how much deposit insurance they want. Some people need $10,000 in deposit insurance. Some people might need $150,000 in insurance. If we priced deposit insurance at its real cost and at its real value rather than at a subsidized price, we could let people decide how much they wanted to buy the same way you and I decide whether we want to buy $100,000 in life insurance or $1 million in life insurance.

So I think we have to look at the pricing of the product. Deposit insurance is a commodity that is produced by the American taxpayers at considerable cost, and we should not be giving it away at below the cost to produce it.

I think if we addressed the pricing of that product and identify some goals about how much of it in the aggregate we want to have, we can begin to reduce the scope of that program.

Senator SHELBY. It is not the best insurance we could come up with, of this committee and the banking regulators, to make the banks better capitalized? In other words, that is the first hit on a bad loan or anything, the capital, is it not?

Chairman **Breeden**. Well that is a critical element.

Senator **Shelby**. And I think so many of our banks are thinly capitalized compared to a lot of them in the world.

Chairman **Breeden**. Yes, sir, I think that is very important, and that is one of the reasons why we suggested reexamining the banking and commerce barrier. If the banks have to go get more capital, we think they should not be excluded from those who have most of the capital among U.S. firms.

Senator **Shelby**. Richard, in your testimony you pointed out that under the Bank Holding Company Act the holding company is subject to oversight by the Federal Reserve, as we know. You suggest, and you remind us, that the White House Working Group, with the concurrence of the Fed Chairman at that time, Paul Volcker, agreed that a nonbank holding company that owns a bank with fewer assets than the holding company should be regulated by its appropriate regulator. If it were a securities firm, the SEC would be the holding company regulator.

You point out in your testimony that current diversified holding companies such as American Express are not regulated by the Fed. However, American Express customers do not enjoy deposit insurance, as I understand it. Without consistency at the holding company level, how do we effectively protect the deposit insurance fund? That is a different twist of what we were just talking about.

Chairman **Breeden**. Well, it is very important that we make sure of the importance of firewalls, and restrictions against dividending money up to the parent, or lending it among other affiliates, ways in which a parent organization could take advantage of the safety net. We need to prohibit that. I have absolutely no quarrel with that.

Deposit insurance, if anything, should be reduced and not expanded. But holding company regulation does not accomplish that. We should not kid ourselves that asking a Federal agency to examine the books of the parent will, on its own, stop that kind of intermingling.

Senator **Shelby**. That is just not enough, is it?

Chairman **Breeden**. That is not enough. And indeed, if you limit the things that can be done with the money of the bank, then having a regulator overseeing the retail stores or other nonbanking activities is not necessary.

Senator **Shelby**. My time has expired.

The **Chairman**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, thank you.

Mr. Chairman, in your opening comment you made reference to the fact that there were 50-some Blue Sky laws, maybe 51 if you include the District, and I wanted to ask you to clarify your remarks in that regard. It is true that currently State governments share regulatory responsibility with the SEC in the securities industries. You have suggested that dual Federal-State regulatory systems impede efficient capital formation here, and that they impose undue costs on the securities industry.

My question to you is: What information has the SEC collected to support that conclusion?

Chairman **Breeden**. Well, I want to emphasize that I am not suggesting that State regulation does not have many useful attributes, certainly the antifraud activities——

Senator **Heinz**. I am not getting into that. I am just asking you: You made a comment. What is it based on?

Chairman **Breeden**. Well it is based on the view——

Senator **Heinz**. What information is it based on with respect to costs?

Chairman **Breeden**. Well if you have to go and file 51——

Senator **Heinz**. I understand there are different filing requirements. I am just asking, has there been a study made of it?

Chairman **Breeden**. I do not know that we have a study that captures the aggregate costs. I would be happy to look at whether we can furnish that. But each and every filing costs time and money to prepare, and at considerable expense particularly for small companies.

Senator **Heinz**. Well that is your opinion——

Chairman **Breeden**. No. That is an inherent fact. I mean, it just does not——

Senator **Heinz**. The question is, these are all questions of cost versus benefits. It seems to me it is not unreasonable to say to our principal securities regulator: Have you studied quantitatively the costs so that one can meaningfully talk about them versus the benefits?

Let me ask you this: Foreign issuers complain most not about State laws but about the stringent disclosure requirements imposed by the SEC under Federal law, do they not? Is that not where most of the complaints come from?

Chairman **Breeden**. Actually they are quite ecumenical and criticize both.

Senator **Heinz**. You get both?

Chairman **Breeden**. Yes.

Senator **Heinz**. Which do you get more of?

Chairman **Breeden**. I have actually heard more complaints about State regulation. In fact, it came up in our recent international discussions about developing a multijurisdictional perspective. The foreign regulators were complaining that a system in which the SEC would accept foreign prospectuses, and they would agree to accept U.S. prospectuses, was not fair. U.S. companies would be able to go to market, and foreign companies would be able to use their prospectus with us, but they would still have 51 States filing requirements that they would have to make.

This is in contrast to what is going on in Europe where, if you get a prospectus approved in France, you can then sell the securities from Ireland to Greece without in fact getting it reapproved in each jurisdiction. That is the exact opposite. They are removing those barriers while we continue to have them.

I hear a lot about that from foreign companies and from foreign regulators.

Senator **Heinz**. But your answer is that there are complaints about both the SEC and the States?

Chairman **Breeden**. Yes.

Senator **Heinz**. What specific legislative recommendations, if any, do you propose to address the concerns that you have expressed about the dual Federal-State regulation of securities?

Chairman **Breeden**. We obviously were trying to address, as the committee requested, the broad outlines of this, and we did not have a specific legislative submission in this area. We think it is important to try and reduce barriers to a national capital market, and any barriers to the flow of capital within the United States reduces the efficiency of, and drives up the cost of, capital.

We would like to see it possible for a company to make a single filing and be able to go to market, even if others look at that filing.

Senator **Heinz**. I understand what your intent is. I am just wondering, are you going to propose anything specific? You do not have the authority to do anything about it now, as I understand it.

Chairman **Breeden**. No, we do not. We are not——

Senator **Heinz**. Are you going to ask for authority to preempt State law entirely, or to some degree?

Chairman **Breeden**. Oh, not at this time. No, first we want to work with the States and see what improvements we can design to reduce these barriers.

Senator **Heinz**. Let me, because I want to ask you some other questions, conclude this segment by saying I think you would be very well advised to work with the States. I think from what I have heard they want to work with you. This need not be an adversarial relationship.

Many of the things you have indicated indeed are of legitimate concern and complexity in filing, but I was about to say, if you had not said what you said, that you would have been a bit inconsistent with what you were saying earlier about maintaining the dual Federal-State banking system. So I am glad that you gave the answer that you did.

Let me ask and probe a little bit on your concept of functional regulation, holding company regulation. Basically you are saying that the largest functional regulator ought to do it, to the extent it is done; that there ought to be an enormous amount of monitoring of transactions between the subsidiaries and the holding company and the affiliates.

I do not know whether that imposes a lot of costs that are unreasonable or not. We did get into this issue when we were considering your legislation earlier this year on monitoring what was going on between the securities affiliates and the holding company. It was a very controversial, as you know.

I guess you and Chairman Greenspan are in disagreement on whether or not there should be a more unified holding company regulator. Citing the Drexel experience, Chairman Greenspan said that he would go further than functional regulation. He says that whatever the regulatory form and structure under which new activities are being permitted, one agency should have oversight responsibility for the banking organization as a whole. The failure of any large financial services firm creates the potential for systemic risk. When we were dealing with Drexel, you know as well as I do that the Fed was very nervous that they were going to have to exercise some of their standby authority in case the situation could not be contained.

Should some form of holding company regulation be a part of any restructuring plan?

Chairman **Breeden**. Well we tried to indicate in the testimony that it may be. It can be done in two different ways. We can have holding company oversight but tailor it down and reduce many of the unnecessary attributes that we have today. Or, in fact we think it could be done by some slight buttressing of the authority of the banking regulator or the broker-dealer regulator, like the Market Reform Act did in the risk assessment provisions. I recognize the controversy over the large trader reporting, but I do not think that is really relevant to this question of holding company structure. A bank regulator, armed with the same kind of authority that we would have under the Market Reform Act, could go look at the parent and make sure that there is nothing going on up in the parent that is causing undue risks in the subsidiary that would also be sufficient.

You indicated we were in disagreement with Chairman Greenspan. I think it would be wrong to overstate the degree of disagreement, I would agree with the statement of his that you just read, that state I would agree that there should be thorough and complete oversight over the banking organization.

If somebody owns a bank, the bank regulators should have absolute and complete authority to monitor, assess, and regulate that bank and make sure that they are not called upon to support that bank in circumstances that they are not comfortable with.

The question is: Do they have to regulate the light bulb factory if GE happens to own the bank? There, I think you cannot really argue that it is necessary to have a banking regulator patrolling the production lines of the light bulb factory to satisfy themselves as to the safety of the bank.

Senator **Heinz**. Mr. Chairman, I know my time has expired, but if I might just ask one brief follow-up question?

The **Chairman**. Yes, go ahead.

Senator **Heinz**. I appreciate the forbearance of my colleagues on the committee, if they so permit me.

I understand, Richard, what you are saying but I am worried about a situation that does not involve light bulbs but involves the subsidiaries of a holding company that, because one or more of the subsidiaries is having a problem, the holding company is having a problem.

The regulators, who are functional regulators, see what is happening and each have the authority to go to the holding company under your scheme and say you have got to raise capital. Another says, you have got to liquidate. Another says something else.

How do you solve the problem of disputes among the regulators? How do you resolve them? Who is going to resolve them?

Chairman **Breeden**. Well, under what I am suggesting, the bank regulator or the broker-dealer regulator would not have the authority to tell the holding company how to fix its problems. What I am suggesting, is that if there is a holding company and it owns both a bank and a broker-dealer, and that holding company is in trouble, whether the trouble comes from the parent's real estate activities or something else——

Senator HEINZ. Well to make the example really nasty, let us assume the holding company is regulated by an agency that looks after a third subsidiary that is not in trouble. But there are two subsidiaries that are, and those functional regulators are saying there is a problem with the holding company and we have got to get on top of it, and the third guy is saying that my subsidiary is fine. Yes, there are some problems with the holding company. But you still have two or three different answers. How do you solve that?

Chairman BREEDEN. I think what we are suggesting is that the regulation has to be focused on where the public customers are and where the risks that we regulate for are. If the problem is with a bank subsidiary and its capital position has been eroded, the banking regulator has to decide when to require more capital to be put into that bank. If the holding company cannot come up with the capital, then you shut down the bank or sell it to another bank.

The broker-dealer regulator, if that is where the problem is, has to be the one to decide—not some holding company authority who may have no experience with broker-dealers. It is the broker-dealer regulator that has to decide when to shut down the broker-dealer and say, sorry, you have to have X amount of capital to operate and you do not have it. Come up with the capital, or you are going to go out of business. Similarly in an insurance company.

I am concerned about having an agency at the holding company level—for example, if you have a holding company with a national bank and a broker-dealer as the operating companies, the two regulators that know about the operating companies are the OCC and the SEC—having the Federal Reserve as the regulator at the holding company level, when it does not regulate either of the two subsidiaries, is not going to guarantee you that one of those two subs is not going to be in trouble. And if you do have trouble, it is those two regulators that have to decide how their subsidiary has to be dealt with to protect the banking system in the one case and to protect the security system in the other.

Senator HEINZ. Suppose the two regulators are the SEC and the CFTC. What happens?

Chairman BREEDEN. What happened?

Senator HEINZ. Oh, my time has expired. [Laughter.]

Chairman BREEDEN. Good. I think I could use a little more time.

Senator HEINZ. I think I did us both a favor on that.

The CHAIRMAN. That question is coming, now that it is out there. I think now is the time to answer it. [Laughter.]

Chairman BREEDEN. Well it is really no different. We of course would love to work together with our colleagues at the CFTC, which we do all the time on a daily basis. That is an excellent example of the point.

Suppose there was one sub in the commodities market and one in the securities markets, and the parent holding company, because of rampant speculation, had gotten in trouble on the commodities side; assume they let that 98 percent leverage get out of hand and booked trillions of dollars of trading and did not have capital to back it up, and as a result the commodities sub had a catastrophic failure. In such a situation what we are saying is that the parent holding company should not expect it is going to be free to upstream the capital out of the broker-dealer and then transfer it over to pay for the losses in the commodities company. The securities regulator ought to be free to say, thank you very much, the capital that is in the broker-dealer is going to stay there because to strip it out, to suck the capital out of the broker-dealer, could cause a failure there and impact the public customers.

Now, it is the job of the CFTC in that example to figure out what to do with that commodities broker that is insolvent in exactly the same way they would have to decide how to deal with it if it was an insolvent commodities broker that did not have a securities affiliate.

So I do not see the problem. The CFTC does have to decide how to handle a failed commodities broker. The Federal Reserve, the OCC, or the FDIC does have to decide how to solve a failed bank, and we have to decide what to do about a failed broker-dealer. There is nothing about having a regulator at the holding company level, whether it is the Federal Reserve, or NASA, or DOD, or anybody else, that is going to prevent that from having to happen. It is the regulator of the operating entity that has to decide how to handle a failure.

And if the commodities or the banking subs have failed but the broker-dealer is still healthy, we should then have the ability to take steps to take that broker-dealer and sell it to Merrill Lynch, or sell it to someone else, before its failure has been triggered by a failure in another affiliate.

Or if a securities subsidiary is failing and has a bank affiliate that is healthy, the bank regulator has to be free to take that bank and sell it or merge it with another before the problems in the securities sub affect the bank.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

I appreciate your responses. Let me, since the train of thought is moving in that direction—this was not my first question, but since we are trying to maintain some continuity here—there have been a number of different proposals kicking around that are a little less than what you suggest in your testimony this morning as a way of dealing with the problem.

The one that I had introduced for consideration here was the narrow bank approach, Bob Litan's approach. I wonder if you might just comment on the merits or demerits of that proposal. While I appreciate that it does not necessarily go to the extent you go, I am just wondering whether or not that approach would have some appeal.

Chairman BREEDEN. Well in some respects that is a much more radical approach than what I am suggesting in that it would dramatically limit what banks can do, and we are not proposing that we do that.

I think the merits of the narrow bank approach are that it is a means by which we can eliminate loan losses. Putting aside what has happened in the S&L's, we have had aggregate loan losses of $81 billion in the commercial banks in the United States in the last 5 years. That is a lot of money. We could have capitalized $1 trillion in lending if we had not had that much in loan losses.

His approach eliminates the risk of future loan losses. Unfortunately, the down side to the proposal is that it eliminates loan losses by eliminating loans. It says that the only thing a bank can do is buy T bills. Well, that means that the corner restaurant or the corner hardware store that in fact would like a $50,000 working capital loan cannot get it from the bank anymore, because they first have to go to Solomon Bros. and get securitized so the bank can buy a security.

I think that is overbroad. I think that the business of making intermediated loans is still something that is valuable in this country. What I would prefer to see, rather than a narrow bank, is something more like a narrow account. I think that we ought to make it possible through reform of both Glass-Steagall and the Investment Company Act of 1940 for banks to offer money market mutual funds. They ought to be subject to SEC regulation. They ought to be subject to the same mutual fund regulation that all other mutual funds are subject to, but there is no reason that the customer cannot have the opportunity to choose either an insured deposit or a money market fund from the bank.

If the insured deposit were carrying a much higher premium and therefore paid a lower interest rate, then more money might go into the money market funds and you would have less potential for loan losses as a result of that. But I am concerned that "narrow bank" goes a little too far.

Senator DODD. Let me come back to McFadden and Douglas. Congressman Schumer and I today or tomorrow will be introducing a repeal of McFadden and Douglas for full interstate banking—a full repeal of McFadden, and then we provide a window for States on the interstate branching, so that if the States want to take a different route, we allow a limited period of time for them to respond to that. I do not think there is any way to get around that.

I wonder if you might comment on that? You have generally commented on it, but I am assuming you would support such a proposal?

Chairman BREEDEN. Absolutely, Senator. I think it is important, and it is time to move in that direction.

Senator DODD. Gerry Corrigan testified when he came here to talk about deposit insurance generally, that a broader de facto safety net in Europe has not produced a crisis comparable to the S&L crisis that we are facing here. Instead, he pins the major blame for the S&L fiasco on the economy and the regulatory failure. That was his focus of attention.

And while certainly we all understand that deposit insurance was a piece of the problem in that it gave the S&L's a greater ability to grow quickly, I wonder if you think it remains a major problem if we address, or properly address, capital requirements and regulatory supervision? And how important is deposit insurance reform, relative to the other suggestions that have been made for financial modernization.

Chairman BREEDEN. I think capital standards and supervision are extremely important. I think they are one of the very important elements and why FIRREA accomplished a great many important things. It was an important piece of legislation because it mandated serious capital rules, and serious accounting standards,

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We have got to make sure that these proposals are sensible and that we build a consensus for doing that. I am trying to do everything I can short of dropping all of our other responsibilities to encourage attention to that issue.

It is not a turf squabble. It is a serious potential risk, at least in our judgment, to the public. I think I would be derelict if I did not make that risk known to you and urge the Congress to take action on it. I certainly have done everything I can to encourage attention to the problem and try to encourage it in a serious, substantive way on the merits.

I do not think it is a question of the competence of either agency. Both the SEC and the CFTC are competent agencies who have competent personnel and work hard. It is not a question that we do things better than they do. It is a question that there is public oversight in one market, and no public oversight in another of the margin practices, and that is a particularly severe risk.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Well, Mr. Breeden, I appreciate what you are saying. You have been a thoughtful and prudent steward of the public trust in the job that you have carried out, and I am not in any way, shape, or form suggesting that you have not been. You have been outspoken on this, and I think accurate on it.

Just as a trailer on that issue, if in fact the administration's position can be countered by independent agencies, I find it troubling that, for example, we have not seen the Department of Agriculture and the Secretary of Agriculture step out on this issue. That is not an independent agency. He is a direct appointee of the President of the United States. It is my understanding that people in that kind of a position are supposed to be following the administration's policy, and we have not had that kind of forthcoming approach from the Department of Agriculture on this issue, again leading me to say that either people are not taking it seriously, do not think it is important, or there are some other agendas going on there.

I do not ask you to comment on that. It is just further evidence in my mind of either ineptitude or some other kinds of agendas.

Chairman BREEDEN. There is a farm bill pending, and I am sure the Agriculture Department has a few things that quite legitimately are taking up their attention. I do not know the degree to which they have been involved in this.

Senator WIRTH. There is no reason you would know that. I just say that I listen to all these different pieces of it and watch this come and go.

Let me ask you a final question, if I might. When Mr. Greenspan was here last week, we talked a little bit earlier in questions back and forth I think to Senator Riegle about Greenspan's testimony on capital standards in the banking industry, and that he was expressing his skepticism of the firewall approach absent a tougher approach, tougher capital standards.

It seems to me that begs the question related to capital standards in the securities' industry as well. Do you think that the capital standards in place in the securities industry are adequate? And if not, is there any kind of an SEC analysis underway to review the capital requirements in the securities industry?

and it made it unlawful for the savings and loan regulator to engage in competition in laxity and keep cutting the capital standards and cutting the accounting standards. That was an important thing to do. We did it too late, but at least we faced up to it and moved in that direction.

I do not think that capital requirements, though, are enough. It is all well and good to require a bank to have 8 cents on the dollar in capital, but that means that they have 92 cents on the dollar that is lent out and that is ultimately backed by the deposit insurance system.

At the same time we raise capital standards or look at our capital rules, we ought to look at how easy it is to get the other 92 cents, and what price you pay for the Federal VISA card, if that is what you want to have.

Senator DODD. Well he had supervision. I mean, he makes the note that unfortunately some people thought deregulation meant de-supervision.

Chairman BREEDEN. And I think you have to be very realistic about that. I agree totally with Gerry on that. At the time we are broadening people's ability to diversify, that should not mean that they get to do so with no oversight and no strings. There should be good, sound supervision. But I guess I also believe that we need to look at the question of how much deposit insurance do we have, and what do we charge for it?

Senator DODD. So that in your view is an important element in this whole thing.

Chairman BREEDEN. Yes.

Senator DODD. I am just curious on the point, having said what occurred in effect when the deregulation effort went forward and obviously new products coming on line required additional supervision obviously, if you are going to expand the universe there, and yet at that very time we actually cut the number of regulators, the total amount. In your view, was that the fundamental mistake? In fact we should have been increasing the number of people at that particular time to supervise the new activities?

Chairman BREEDEN. Well, yes, at that time I think the number of regulators was not sufficient. Their compensation was not sufficient. Their training was not sufficient. I think really all the financial agencies ought to be able to have some form of self-funding and be able to pay salaries necessary to attract and then retain talented people.

As you know, it is something I am worried about at the Commission. I think that was certainly one of the mistakes that contributed to the S&L problem. But I do not think you can pin the whole situation on that. We allowed the thrifts to add $650 billion in loans in a period of about 7 years. Even if we had given the Bank Board another 500 regulators, as long as we were having that volume and speed of growth, I think we would have had some of the same problems.

So we should have done both. We should have had more regulators, but we also should have said that we are not going to give you this ability to suck in that much funding and grow that quickly. That left the growth rates to get totally out of control.

Senator DODD. I gather, too—and let me just jump back to the McFadden-Douglas issue. In your view, that should have happened yesterday? I mean, it cannot happen quick enough, is your point.

Chairman BREEDEN. Well, 1928 is possibly when we should have realized that McFadden was a mistake. [Laughter.]

Senator DODD. I should not have asked that question.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Dodd.

Senator D'Amato?

Senator D'AMATO. Thank you, Mr. Chairman.

Dick, I want to say that on a number of key points I think your testimony was very incisive as it relates to the firewalls and the necessity for them, particularly as we move into an area of modernization. I could not agree with you more. And seeing to it that there is more competition, and you do not disadvantage one segment of the financial community as opposed to the other. I think that is very important.

I am going to depart, if I might, and touch on some areas not so much with the financial modernization but maybe some of the concerns that we have as it relates to the market today.

Let me ask you this: What benefit, if any, do you see as it relates to computerized trading and its relationship to the individual shareholder, the small guy? Do you have any concerns about it as it relates to that individual?

Chairman BREEDEN. I do not have concerns over the utilization of any form of technology, whether it is telephones, FAX machines, or computers. I think we cannot start restricting the tools that companies utilize.

I have a very great concern over the unsafe levels of leverage that are permitted in the stock index futures market and the fact that these levels then set up a destabilizing need to have what many regard as an index arbitrage to react to the swings in that market. But I do not think you can blame the computer for that; you have to blame the leverage standards for that.

Senator D'AMATO. Well let me be more specific, then. The leveraging that makes possible the arbitrage, therefore setting in these huge sales instantaneously, those sales do not really inure, and the profits do not inure to the benefit of the individual shareholder, do they, in your opinion?

If you are looking at——

Chairman BREEDEN. Profits——

Senator D'AMATO [continuing]. Or to analyze where those profits go, how much of them go to the individual investment houses themselves?

Chairman BREEDEN. Well it is proprietary or for their customers in some cases, which would usually be large institutions. I do not think there are many retail investors who are doing index arbitrage. There may be some.

Senator D'AMATO. How would you deal with that problem? Do you think it is a problem that has to be dealt with?

Chairman BREEDEN. Absolutely. I very strongly think we should deal with the problem, and I think we cannot treat the symptoms. We have got to go to the source of the disease. The source of the disease is 98 percent leverage in the stock index futures market with absolutely no controls, no form of public oversight whatever——

Senator D'AMATO. Right.

Chairman BREEDEN [continuing]. On the level of borrowing and speculation that goes on in the stock index futures market. That is where the problem is, and that is what we have to face up to.

Senator D'AMATO. Do you have a problem dealing with that?

Chairman BREEDEN. The administration has submitted legislation that would, I think, deal very effectively with that problem, and we support it.

Senator D'AMATO. I understand that specifically, though, going into some of the specifics as it relates to what you would do as it relates to regulating this phenomena that takes place, what would you propose? Is there a bottom number as it relates to the amount of equity that someone would have to produce if the margin is now at a level which you feel is much too risky? Then what would you think would be a bottom level, a minimum requirement?

Chairman BREEDEN. Well of course margins that are appropriate vary with economic conditions, and they move up and down. At least margins on options and stock index futures both move up and down. On the stock side it has been fixed since 1974, I think that was the last time it changed.

I would say that what we have to do is to eliminate what we now have, which is a race to the bottom. Whatever level one margin gets set at, the other market can go set a lower margin to try and attract volume. Whether the margin, at any given point in time, ought to be 12 or 14 percent, it ought to be the same for the options market and the index futures market so that nobody is trying to make personal profit from volume by encouraging higher borrowing.

Then I think whatever levels those are should initially be recommended by the SRO's, the exchanges. If they came in and proposed 98 percent leverage some agency—we originally suggested the Federal Reserve—ought to have the right to say, sorry, that is too low. That imperils 50 million people.

Senator D'AMATO. Well let me ask you this. Failing the enactment of the comprehensive legislation which the administration has put forth, you cannot feel too sanguine about the volatility of the market.

Chairman BREEDEN. No. We have tried to express, and some have tried to trivialize it into a regulatory dispute between agencies, the fact that having a market built on 98 percent leverage is not a very safe market.

Senator D'AMATO. It is dangerous.

Chairman BREEDEN. It is dangerous to not only themselves, but the explosion, if there is one, can cause some shrapnel that will hit other people.

Senator D'AMATO. Well let us go a step further. If as a result of the conflict that is being put forth and being advanced by some as a reason not to enact this legislation, suppose we are not able, should there not be some interim steps taken short of the comprehensive proposal which has been put forth in the administration's package?

I am very much concerned that we can have another situation where we see the kind of drop of 200, 300, 400, 500 points with no one there to cushion it, and then we are all running around and the administration comes forth and says, see, I told you so. But what does that do to the confidence of the market and to the small investor and with the losses that are taking place not because of the real economic conditions but because of the manner of the manipulation that we see taking place today, which is absolutely scandalous.

I am going to ask you, if we do not see any dealing with this, should you not take some kind of remedial—should we not take some kind of remedial action to deal with this? It may not be as comprehensive as you have put forth in terms of seeking to regulate, but I do not see us just simply moving in the direction of treading water waiting for the next tidal wave, or the next wave to bury us and hope that we are able to swim back up to the top. I just think that is terribly dangerous.

Chairman **Breeden**. Well, Senator, I share your concern that we should not be complacent, and these problems that we have seen twice already will not reoccur. We can identify—and in fact, every independent observer has identified—that over-leverage, with absolutely no form of public oversight over the level of borrowing that goes on in the stock index futures market, is a mistake and ought to be cured.

Now I support the administration's legislation——

Senator **D'Amato**. I understand that.

Chairman **Breeden**. I would rather see us go forward with the proposal as it has been made. I think one could conclude that the question of whether stock index futures jurisdiction should be shifted, or whether something like the Eckard bill to merge the two agencies ought to be done—one could continue to study that question.

If we took more time to study that question, the world would not necessarily come to an immediate end. But the margin question and the exclusivity problems that underlie two of the three pieces of that bill certainly pose a continuous and ongoing risk to the public.

If you are asking me to identify which pieces of that bill are the most critical that we do as early as possible, it is margins and exclusivity. I would like to see us do all of them. In the meantime, we hope that Congress will address some of those problems. I strongly encourage you, while this year is still here and Congress is in session, to deal with some of those problems.

Next week we are also going to be taking up rule 80(a), a rule proposal of the New York Stock Exchange which is designed as a bit of a stop-gap, to put in place some circuit-breaker type provisions.

Senator **D'Amato**. Mr. Chairman, my time has expired, but with the indulgence of the Senator from Colorado, I have just two quick follow-ups, if he might permit me.

Senator **Wirth**. Please go ahead, by all means.

The **Chairman**. Yes. Please continue.

Senator **D'Amato**. First of all, I appreciate, Dick, the candor of your response. I think it is absolutely terribly critical that you be prepared to come forth with the most vital parts, even if we cannot get the totality.

Given the political realities of the turf battle that at least in the Congress exist—I am not saying with respect to yourself, but in the Congress exists—I really think that we ought to try to do the best we can, because I am just very fearful that we are going to have another debacle out there. The implications, particularly in light of all the economic problems that we have, I think these are going to be much more severe than they have been in the past. So I would encourage you to continue forward with alternatives.

Second, let me ask you: What impact, if any—and this again may be going afield, but I am very much concerned that if indeed in our search to produce additional revenues we come up with a stock transfer tax, that we could do great violence to the market and to the viability of this being the world's premiere marketplace. Given the liquidity that we have had and the investor confidence that we have had, et cetera, I think that that might be something that would be terribly detrimental.

What is your feeling about a stock transfer tax?

Chairman BREEDEN. Well I think we have to be extraordinarily careful in creating taxes on capital formation. We already have some of the world's highest taxes because we have no relief for capital gains, no relief for double tax on dividends. We have a very high cost tax structure for capital markets. If we make it worse, we could potentially do some damage.

It is instructive to look back. In 1980, the U.S. equity market was four times larger than the next largest market in the world, which was Japan. We were four times the size of the Japanese market. The 1990's began with the United States, the Japanese, and the EEC markets essentially of roughly comparable size.

So, foreign investors who have used the U.S. markets have some alternatives now, and I think we have to be very careful that we do not take steps that drive trading offshore.

Senator D'AMATO. One final thing, and maybe it is an observation. If you care to comment, I again thank the Chairman and my colleague from Colorado, Senator Wirth, who has given me this additional time.

Basically it came about for the little guy, the $10,000 depositor, and then they raised it to $40,000, to say that his life's savings were going to be protected. Now who is to say that the little guy in terms of today, a life's savings of $100,000, I am not going to say it is too high or too low, and it may be very reasonable, but I think when we go beyond the multiplicity where people can break up—people of substantial worth can break up $2 million, $1 million, and put it in 10 different institutions, I think that violates the spirit of what Federal deposit insurance was initially intended for.

Would you care to comment on that?

Chairman BREEDEN. I agree that we have far, far more deposit insurance in use today than is necessary to solve the original purposes of the program. In fact, only 1 percent of the depositors today represent 28 percent of all insured deposits in America. So you could reduce the size of the program by 28 percent and still fully cover 99 percent of the depositors.

Senator D'AMATO. Why not simply one person is allowed $100,000 FDIC insurance wherever they place it. That's it.

Chairman BREEDEN. That is one way of limiting the program. I suggested earlier there may be other ways. There may be more flexible ways of being sure that we accomplish the original goals of letting people who want to protect a certain amount of money and be sure that they are not exposed to risk of bank failure, let them do that, but without trying to insure the entire capital market.

I think I would like to look at the full range of suggestions, and I think the Treasury Department is doing that, of ways to get us back toward solving the original purpose of protecting depositors and protecting the stability of the system, but doing so with less of the aggregate amount of deposit insurance than we have today.

Senator D'AMATO. Thank you, Mr. Chairman, and thank you, Dick.

The CHAIRMAN. Thank you, Senator D'Amato. I think those were important questions, and I think that really helps fill out the record.

Senator Wirth?

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Breeden, I am pleased to have you here and appreciate the good work that you are doing on behalf of the safety and soundness of the securities industry and that set of financial institutions that I think have been cared for.

If we look historically, if I go back 10 years—I have been involved with this for a little longer than that—but if you look at that kind of breaking points, during the 1980's if we look at the four separate kinds of financial institutions that we deal with—the securities industry, the savings and loan industry, the banks, and the CFTC—we have various levels of deregulation in each one of those.

There was a major deregulation of the S&L industry. That occurred, and we are all familiar with that, in 1982, and then the desupervision.

On the banks there was an attempt during the 1980's to really get rid of Glass-Steagall, and that was resisted you remember in the House of Representatives. The House Banking Committee and the House Commerce Committee had very different perspectives on that, and that never got anywhere, maybe for substantive reasons and maybe for jurisdictional reasons, but Glass-Steagall was maintained.

The third area, your area of jurisdiction, the Securities and Exchange Commission, you remember Chairman Shad came in 1981 and made a major case for deregulation of the securities industry, claiming that "we can do more with less." That was the famous quote. We then had a number of hearings on that subject, and it turned out the other four members of the SEC did not agree with that and it was a little bit embarrassing for the chairman at that time, but not only was deregulation of the SEC not allowed but we strengthened the commitments of resources to the SEC.

The final area, which is the one at issue now, is the CFTC/SEC relationship. In 1981 or 1982, I remember there was the so-called Shad-Johnson accord which effectively would have given most everything away to the CFTC. The Congress insisted on maintaining for your jurisdiction, for the SEC, a hold on the approval of various instruments that would be offered by the CFTC. If they impinged upon the securities market, they fell within your jurisdiction and you had to approve on that.

Now the reason for that goes beyond—and I think you quite correctly described it—it goes far beyond the trivialization of this as a jurisdictional issue; it went to the point that it was believed by many of us that these financial institutions are special, and that they do demand a kind of nurturing and a very kind of careful—they are not like drug store products; they are not like products in the grocery store. You do not deregulate them willy nilly, but you have to have sort of an overall strategy.

It was believed that when the SEC was given the jurisdiction, or maintained the jurisdiction over new instruments, that you all would have a long-term view of the value of these instruments, how they fit in the economy, and they were not to be just traded willy nilly like pork bellies and so on. That is an over-simplification, but that was the summary of why we did not agree with the Shad-Johnson accord and made a part of the jurisdiction for you.

We are now back at this issue. Eight years later we are back at the issue, following the Brady report and the concern about margin requirements. Now it is my understanding that it is the administration's position now, the administration's overall position, that the SEC ought to have greater jurisdiction in this area. Is that right?

Chairman **Breeden**. That is correct.

Senator **Wirth**. That is the administration's position. And is that position followed by you at the SEC?

Chairman **Breeden**. Yes, sir.

Senator **Wirth**. That is, your position and the administration's position are the same?

Chairman **Breeden**. We support the legislation that the administration has introduced in the Congress; yes.

Senator **Wirth**. Do you have an obligation to do that as an administration appointee? Could you oppose the administration's position as Chairman of the SEC?

Chairman **Breeden**. As the head of an independent agency, we do have an obligation to exercise the independence with which Congress has entrusted our agency. So, I support that proposal because it is a good idea. It is the best way I can think of to protect 50 million people who participate in the securities markets. It would also reduce costs that are completely unnecessary. I support it not because anyone has told me to, but because it is the right thing to do.

Senator **Wirth**. Are you generally expected as an appointee of the administration to support the administration? If the Secretary of the Treasury or the White House takes a position, are you generally expected to support that position?

Chairman **Breeden**. I am never sure what they expect of me.

Senator **Wirth**. You would assume that you would—I would assume that you would, as a Presidential appointee, would be carrying out the directions and the policies of the President of the United States. Is that not——

Chairman **Breeden**. I am almost uniformly delighted to support the policies of this President, who I think is doing a superb job, and whom I have had the privilege of serving.

Senator **Wirth**. Well certainly he is elected by the American people, and I would think the American people would expect him to be carrying out these responsibilities. Obviously I am leading to something. [Laughter.]

Tell me, does the CFTC support the administration's position?

Chairman **Breeden**. The CFTC has opposed, quite strongly and quite vigorously, the legislation that the administration has submitted.

Senator **Wirth**. Now Wendy Gramm is the Chairman of the CFTC?

Chairman **Breeden**. Yes.

Senator **Wirth**. Now she is an appointee of the President?

Chairman **Breeden**. Yes.

Senator **Wirth**. She is in a similar position as yours?

Chairman **Breeden**. Yes.

Senator **Wirth**. And she is running counter to the administration's position? Is that right?

Chairman **Breeden**. Yes.

Senator **Wirth**. Why? I find it—is she up for reappointment now, too? Is that right?

Chairman **Breeden**. The President has renominated her, subject to confirmation.

Senator **Wirth**. Even though she is running counter on the issue probably that is maybe as visible as any other related to all of the concerns about the long-term future of the economy. I am just astonished that we have an administration position and presumably the administration comes to that position, appoints people; somebody in your position adheres to that—you think it is a good idea in any case, but you be intending to do so—and yet you have the other agency veering off 180 degrees in the other direction, and the individual is reappointed by the administration for disobeying orders? I have never seen a situation like this before, I guess.

Chairman **Breeden**. The appointment process obviously is one that takes into account a lot of factors, including generally job performance as a whole. I am sure that Chairman Gramm was renamed by the President because he thinks she has done a good job in running the CFTC, and in looking at things as a whole, and he believes she ought to continue to lead that agency.

There may be times when independent agencies express disagreement with the prevailing policy of the administration. Frankly, as strongly as I feel about the CFTC issue, I would want to express the importance of the head of an independent agency being able to express a contrary point of view.

There could come a time when some in the administration might decide, for example, that the level of supervision in a given area ought to be reduced. Frankly, if someone were proposing what, in my judgment, was an inappropriate level of reduction of the SEC's oversight, I would speak up against it. I think people have to make a judgment of at what point they can reconcile serving in an administration and disagreeing with its policies.

Senator **Wirth**. Well you are a good soldier, Mr. Breeden. I find it—if this issue is as important as you say it is, and as important as the Brady Commission report said it was, and as important as Secretary Brady says it is, it is not a trivial difference between agencies. It is not a jurisdictional spat. It really goes to some of the fundamentals of what is going on in our economy. I mean, I believe it has the potential of doing that.

I believe that if you run up this kind of leverage, as we have seen before—you cited the other two instances and we hope it does not happen again, but it certainly could. Certainly with the market as fragile as it appears to be right now, I would think that the chances are as great of it happening again as not—I do not know if I would say "as great," but it seems to me there is a very significant danger.

Now if in fact this is the administration's position, it seems to me that they ought to be vigorously pursuing getting this legislation enacted, legislation that they have introduced at Treasury and that you all have supported.

So I come down and I say, well, why have they not done this? I mean, if it is as terribly important as they say it is, then they ought to be pursuing it and pulling all the stops. You know, they pull all the stops on the civil rights' negotiations. They pull all the stops on vetoing of parental leave. They pull all the stops on a variety of other things.

Here we have these special institutions that are enormously important for the value of our economy that have to be treated in a special way, and they are not pursuing that. It creates a—all you can come back to is to say, well, maybe they just think it is a jurisdictional spat. But you say it is much more important than that.

Chairman **Breeden**. Well I think the administration has been pursuing this. I know Secretary Brady was here before this committee just last week expressing himself on it. So I think the administration has been supporting that legislation.

Senator **Wirth**. Well the single most important statement they are making is to reappoint the person who is undermining, torpedoing, eroding away, hacking at the roots of their very policy more than anybody else. That, it seems to me—I do not understand that. If they are supporting it, why are they reappointing the person who is going around and sticking it to them as hard as possible? Does that not appear to you to be a contradiction in policy?

Chairman **Breeden**. Happily, I never had the responsibility——

Senator **Wirth**. I understand.

Chairman **Breeden** [continuing]. For personnel, when I was in the White House.

Senator **Wirth**. You are a good soldier, and that is not an appropriate question for you. I find it quite remarkable and can say: What are the explanations?

One explanation is that they are petrified of Wendy Gramm because she is married to a distinguished member of this institution, a very powerful one. So they do not want to take that on. That is more than they want to take on. That is one explanation.

That trivializes it, again to use your I think good word, you used it in another context, but that trivializes the reason, but I think there is an important election going on and so on.

The second one is maybe they do not think it is this important. But I believe they do think that it is this important.

And the third explanation that I can come up with is that—and this becomes a very cynical one—is that the administration is saying, OK, we are going to kind of make this effort. We are not really going to pull the stops on this. We are just going to try to make the effort and make it look good, put it up there in the lights, you know. It sounds good if you say it fast enough. We will not do any work on it to speak of, but we are going to try to get this passed.

Then when it does not pass—and I think right now it is looking very shaky up here—when it does not pass, they can say, see, we told you so. It is just a matter of the Congress doing its—being an inept institution, or it is a matter of all the contributions that Members of the Congress receive from Chicago exchanges, and so on, and it is just like the S&L scandal. They draw that kind of a parallel out and they say, see what is happened on the CFTC? It is going to lead us to something like the S&L scandal. We made a proposal to clean it up. It did not get cleaned up. Now it is the Congress' fault. And it is just like they acted on the S&L.

Now I can come to no other conclusion but that that is what is going on, that this is a very cynical political exercise not to pursue as aggressively as possible a policy which the Brady Commission, which the Secretary, which you, and which almost every other thoughtful individual has said ought to happen. They are not doing it. Why? I cannot figure it out. It is not the trivial reason because of who Wendy Gramm's husband is. It is not because you do not think it is important. There has to be some other reason for operating in this ambivalent—more than ambivalent, mutually exclusive fashion.

Chairman **Breeden**. Well I think another possibility is that—and I would disagree with the suggestion of cynicism involved in this—there is a genuine belief on the part of the Secretary of the Treasury, that in financial policy matters he speaks for the administration. He has made it very clear with legislation introduced by the administration, that the administration genuinely believes this is a serious problem that puts the Nation's capital markets at an unnecessary risk and should be cured.

At the same time, it is possible, as we all recognize, that these financial regulatory questions are not open and shut, black and white. There are always two sides to an issue, and there is value in letting there be a full and informed debate, and allowing someone who disagrees with the policy, nonetheless, to express his other reservations and hope that, nonetheless, the administration will prevail and to work hard toward that end.

I think there are many occasions in which any administration does not go around ordering people to simply avoid speaking their mind when they feel strongly, for legitimate policy reasons, that something the administration is supporting is a mistake.

Now, usually that kind of debate goes on before the policy is adopted, and then once a policy is established people support the policy of the Government. However, I think one should not undercut the ability of the head of an independent agency to express disagreement for serious substantive reasons—as much as I might disagree with them, and as much as the Secretary of the Treasury might disagree with them—that their point of view ought to be out and on the table, so that on deciding on that issue people have the benefit of a full view of the pros and cons.

Some would argue that we should have had more of that kind of candor in the past rather than less. But I would like to say, since the subject has been raised, that we have a system where trading in S&P 500 stocks and trading in the futures on S&P 500 stocks is trading in the same thing. It is the same underlying S&P 500 stocks. You can liken the current system to air traffic control, as if had we decided to build one tower to control takeoffs from National Airport, and a different tower to control landings. If we kept watching near mid-air collisions with 747's packed with people, I do not think it would be appropriate to take the posture of saying, well, we have not had an actual crash yet. Notwithstanding the fact that we have seen several near-misses, are we going to wait until we finally see a disaster occur before we do anything? I like to think that, particularly with respect to the question of a market based on 98 percent leverage, Congress, working with the administration, should say that this creates an unacceptable level of risk to other people that should not be tolerated, and that there needs to be some form of public oversight.

Whether it is from the Federal Reserve, the SEC, or whatever agency, it is not an agency turf question; it is a question of protecting the American public. I think we have a duty to speak up for that and to try and accomplish that.

The **Chairman**. Would you yield just a——

Senator **Wirth**. I would be happy to yield. I agree with that completely. Chairman Dingell and I were the people that got your chop in the early 1980's so that there was some FEC jurisdiction. In looking at this, I agree completely that we ought to have one tower looking at this.

I do not understand, again, why after clearly having hearings on this subject within the administration, it is not as if the CFTC did not get a day in court. I know there were significant days in court. A great deal of debate went on for a long period of time. It took a long time for the Treasury Department to come out with their position on this.

A number of us were pressing them. Where is it? What are you going to do? They were trying to get their ducks in line, and I appreciate that. That is what an administration ought to do. But once you get the ducks in line, it seems to me, you expect everybody to kind of go with that kind of a flow and not in this other kind of fashion. I find it very bewildering and disturbing, and I think it is very dangerous, as well, to let that happen given the fact that we have got these 747's up there.

Excuse me.

The **Chairman**. Well I just want to ask a related question. That does not for the moment get into all the tactical work that has been done, or what have you, or what may not be being done.

In your professional opinion, you have been at the SEC now for some period of time, how urgent is it that this be done? How significant is the risk that you see to the country and to the financial markets to leave this matter unresolved?

Chairman BREEDEN. I think it is a very serious matter and needs to be addressed. It is impossible to quantify or predict whether something——

The CHAIRMAN. Do you have a more important priority at the moment than that one?

Chairman BREEDEN. My first and foremost priority is to do everything in our power to administer the securities laws and to do so as well as we can. Let us remember that, as important as the $20 billion stock index futures market is, the $3.5 trillion securities market is my principal concern. I wake up in the morning, and I go to bed at night worrying about protecting investors in that marketplace.

The CHAIRMAN. But are you not saying you think this creates a risk in exactly that area?

Chairman BREEDEN. I cannot come up with any mental explanation for a need for the market to run on 98 percent leverage.

The CHAIRMAN. No. I understand.

Chairman BREEDEN. I would like to see that curtailed so that it does not risk the securities market.

The CHAIRMAN. You have made that point. I want to understand where, though, in terms of all the priorities that you are dealing with with this particular item, and where this is on your list of operational requirements and urgent matters. Is this the top item in terms of something you think has to be addressed, has to be changed? Is it third on the list? Is it down in the second tier of items?

I am trying to get a sense in terms of what you think the potential risk factors are that are associated with this as to how urgent it is that this be done, at least in your professional view.

Chairman BREEDEN. I do not want to be resistant on this Senator, you have had a chance to meet all three of my sons, and if you were asking me to tell you which of those three sons I liked better I would have a hard time doing it. I cannot tell you that, legislatively, this is more important than the Market Reform Act.

The Market Reform Act is very important to allow us to control some risks we have also seen and that we need to deal with. The Enforcement Remedies bill was very important to deal with enforcement gaps that have opened up.

The CHAIRMAN. Right. We have moved that through.

Chairman BREEDEN. So those are moving. This is, like those statutes, a very important legislative initiative to try and control something that we have seen nearly cause a massive problem twice before. I rate it, professionally, at a very high priority. I cannot tell you that it is to the exclusion of all other things.

If we cannot move forward on that, we will have to do the best we can to try and prevent the kind of risks that have been created in the index futures market from impacting unduly the stock market.

The CHAIRMAN. Well without addressing in detail the merits of that argument, because this is not the forum in which to do that today, but I would have to say that with respect to something that Senator Wirth has said, that there is not a full-court press going on that is observable. We see those when they happen.

If there is an issue like the civil rights issue or something else that is seen as a top operational priority, we tend to see former Governor Sununu in the act pressing hard, making calls, attending meetings; sometimes we see the Vice President. We often see the President.

In other words, there is a whole pattern of all-out effort when an item reaches that level of priority for an administration. There is really no sign of that. I do not say that disrespectfully to anybody. I know Treasury Secretary Brady feels strongly about it, and he has expressed himself, as you pointed out, before this committee. But that is a different matter. In other words, that is a formal presentation in this setting and so forth.

But in terms of an all-out effort to get this accomplished, I am not seeing that. I tell you that. Perhaps you are seeing something that we are not, but there does seem to be something of a gap between what I hear you saying in your view is a matter of really very significant importance. Now obviously that is your view. Others have a different view.

And leaving the arguments aside for the moment, that is your view and I think it is also fair to say at the same time that I do not think it has gotten that kind of an operational priority in terms of actually going out and putting on the full-court press.

Chairman BREEDEN. Mr. Chairman, I would perhaps plead guilty in part to that. Although I would hope that my views on that are not unknown, since I have had the occasion to testify solely on that question three times and express myself on some other occasions such as today. But I have not been personally lobbying the members of the Senate on this question.

As you know, we have discussed it here on this committee, but I have not been trying to button-hole everyone to discuss it. I would hope our testimony on the record would reflect what we think about that. I think it is an administration proposal. It is an important one. The one hopeful thing, so that we would not be too negative on this, is the current margins that are being imposed by the stock index futures markets are at levels that are not at the 98 percent leverage that we have seen in both the 1987 crash and the 1989 problems.

Happily, so long as Congress continues to debate this question, the futures markets may not feel free to go back to 98 percent leverage. So, at least in terms of saying what is the risk tomorrow that we will see the kind of problems that we have seen twice in the past, I think right now the margin levels are at much more appropriate levels.

The problem simply is that for the future, if there is no action, there is no protection and no guarantee that a year from now the margins will be back at 2 percent, and we will not be right back again with 98 percent leverage. It is to try to protect against that future risk that make us think that action is important.

But, I would not want to suggest to the markets or to the Congress that we are talking about a matter of life or death, an imminent collapse of the market. We are talking about a risk that we have seen twice in the past, and we ought to take steps to eliminate it.

Chairman **Breeden**. Well, Senator, we actually have a public rulemaking underway to review some deficiencies that we have already identified in the capital rules, and are seeking public comment on other ways we ought to modify them, particularly in light of the Drexel situation. So we are working actively on that subject.

Senator **Wirth**. So the answer is that you are taking a look at it. There may be problems, or there may not be problems, but you are looking at it.

Chairman **Breeden**. Well we have made some specific proposals contained in that rulemaking. It is not just an abstract inquiry. For example, we have proposed that a broker-dealer would have to report to us in advance of any reduction of their excess capital of more than specified amounts in any particular month, or in any 3-month period. That is a reflection of what we saw occur in Drexel where substantial amounts of the capital were removed between the reporting periods.

We are moving to plug that gap and to also change some of the minimum capital standards as they apply to firms doing a lot of proprietary trading, which again Drexel was actively engaged in. Rather than basing capital solely on customer liabilities, we're also setting a standard based on the level of the firm's own haircuts—a percentage of the firm's total aggregate haircuts reflecting its proprietary trading.

So there are some very specific improvements we have proposed to make in the capital rules, we have also invited comment on further changes that ought to be made.

Senator **Wirth**. Thank you very much, Mr. Breeden.

Mr Chairman, I wanted to get into just a little bit more on the deregulation of financial institutions and Mr. Breeden's proposal, but I would just close by adding for the record Gerry Corrigan's comments on this. He testified before this committee on May 3, 1990. Mr. Corrigan, the President of the Federal Reserve Bank of New York, stated:

> I strongly oppose the merging of Banking and Commerce and any arrangements that would remotely contemplate the ownership and control of bank holding companies by commercial concerns.

Mr. Corrigan cited concerns about the concentration of economic power, conflicts of interest, unfair competition, and the breach of fiduciary responsibilities, and said:

> In no other major countries are banks as a general matter owned and controlled by commercial companies.

I think we have just been through a paroxysm of deregulation in the 1980's. We have levels of it. As we described earlier, I think we want to be very, very careful, especially careful now before we go any further, and in fact I think we ought to spend more attention trying to draw back and make sure what we have got are being done right. That was the purpose of my questions on capital requirements in the securities industry. I think that is why we want to be very careful on the CFTC/SEC relationship.

That leverage question I think ought to obsess us before we go any further I believe in the deregulatory direction.

Thank you again, Mr. Breeden. I appreciate the job that you are doing down there.

Chairman **Breeden**. Thank you.

Senator, if I could just give you a very brief reaction to that, though. I think we agree eye-to-eye, absolutely, and completely that we have to be serious about financial regulation. We have seen the kinds of risks that can occur and the kinds of damages. Sometimes they are direct in the form of failures of firms. Sometimes they are indirect in the form of conflicts of interest and other problems that can develop.

I have spent a good deal of my professional career worrying about some of those problems and treating them very, very seriously. My suggestions on banking and commerce were not that we ought to deregulate banking. Even if in the future a bank were owned by General Electric, just the way General Electric owns a securities firm—that securities firm would not be deregulated. We regulate Kidder-Peabody exactly the same way we regulate Morgan-Stanley, or some firm that does not have a commercial parent.

So I am not here today advocating the abolition of regulation, or advocating that we not take that very seriously. What I was suggesting in that area was that banks do need capital, and most of the capital in the U.S. economy happens to reside in firms that engage in other commercial activities.

While we saw a lot of S&L failures, the S&L owned by Ford Motor Co. was not among the failures. It has proved a source of stability in S&L's, in securities, and in other areas for us to be less restrictive in the types of lines of business that a parent may be engaged in. I have a particular problem in having us say that it is all right for a Japanese bank that has commercial affiliates in ship building, and auto manufacturing to buy a U.S. bank, but it is not OK for a U.S. firm in the exact same lines of business to buy a U.S. bank.

I think that is a formula for turning over ownership of the U.S. banking system to more foreign corporations than would otherwise occur. I am not advocating anything radical. I am advocating that we reexamine that question carefully, prudently, and thoroughly, and if there are assertions of conflict of interest or problems, let us get them out on the table and not just dismiss them with an assumption that we could not do it another way.

Let us take a careful look at that, because I think we are being more restrictive on who can own the shares of a bank than we need to be and still maintain 100 percent of the safety that we currently expect of banks.

Senator **Wirth**. That is a good answer. Thank you, Mr. Breeden.

Thank you, Mr. Chairman.

The **Chairman**. Let me raise just two other questions with you. Do you know or have any idea when the administration will introduce a financial services modernization package?

Chairman **Breeden**. No.

The **Chairman**. Do you expect one within a year?

Chairman **Breeden**. Well I know the Treasury Department is working very actively on both the deposit insurance study and proposals to make changes in Glass-Steagall and other areas. I know there is a great deal of work going on at Treasury, but I cannot give you a date on which they may propose it.

The **Chairman**. Are they putting a package together?

Chairman BREEDEN. Well I think they are at the stage of doing a careful review of the issues and being prepared—I think they are moving toward having a package next year.

The CHAIRMAN. Early next year?

Chairman BREEDEN. I know Secretary Brady is going to be here in the very near future, and I think he could give you a better answer on the timetable than I could.

The CHAIRMAN. Are you participating in that work?

Chairman BREEDEN. Well, yes, in the sense of frequently discussing these issues with various people in the Treasury and elsewhere in the Government.

The CHAIRMAN. Who is in charge of it?

Chairman BREEDEN. Well, Secretary Brady is in charge of the Treasury's work, and others certainly——

The CHAIRMAN. Who is leading the Work Group?

Chairman. BREEDEN. Well it is not in the form of a formal Working Group. I mean, I have discussed these questions with other members of the administration generally in an informal way. There is no formal working body that is crafting a specific bill at this moment, at least where we are a participant.

I think the administration does have a number of Cabinet Working Groups that are looking at cost of capital, and looking at modernization. As an independent agency, we would not normally participate in that kind of formal process, but we certainly try and——

The CHAIRMAN. Well you have a highly relevant background, though. I mean, you worked with the now-President over a long period of time in this area, and you are obviously a top professional that relates to many of these questions. I would think they would draw you in for the discussion and idea side of this, would they not?

Chairman BREEDEN. Well as I say, I have very frequently discussed this with people in the White House, the Treasury, and other places as we are talking about these kinds of issues.

The CHAIRMAN. Let me ask you this. Do you have a sense that this might end up in being one of the top say five legislative priorities in 1991? Or do you have no sense at all for that?

Chairman BREEDEN. Mr. Chairman, again I do not think it would be appropriate for me to characterize for the administration how they will rank their legislative priorities for 1991.

The CHAIRMAN. Well let me give you a thought related to that. I mean, you have been around long enough to know how the legislative calendar works, and we are winding down through the remainder this year. We obviously will not be getting a proposal this legislative year based on what you have just told us about what the work process seems to be. So the earliest that we might get one and be able to do anything with it would be sometime in the next legislative year.

Obviously once we go through the remainder of this year and we have the November elections, and then we start the next session of Congress, we are into the Presidential reelection cycle. We will be in the cycle that leads up to 1992, and obviously the last 2 years of a 4 year term becomes very intensely impacted just by the shear mechanics of having to run and seek reelection.

It has been my observation, and this is my 24th year here, that normally in that third year of a Presidency as the reelection cycle is starting, that very careful decisionmaking has to be made as to what goes on the short list of top priority legislative items. In other words, you cannot go after 50 or 30 things.

Normally if you have got 3 or 4 or 5 major priorities—and I am putting that now also in the context of something like that: Financial modernization package breaks new ground. I mean, you have to go in and you have to reshape organizational structures. It is not your garden variety kind of legislative proposal. It is something that is more complex. There is likely to be parties at interest that collide on this, and so forth.

So to get it done, not to just sort of throw something out there and have a tip of the hat toward a subject, but to actually get it done in 1991, and in advance say of Europe 1991 and other international developments, my own view is that that happens to be on the short list of administration priorities very early in 1991. I am just thinking aloud with you here, as a colleague, if you will, because we have had a very serious discussion here this morning on the substance of these questions.

It seems to me that if we are going to hit that legislative window—and I am for hitting it—I think these issues are important. I think time is running against us. I think we are late in responding, for a lot of reasons, including differences in opinion in the House and jurisdictional questions over there and a variety of other things—but if we are going to hit that window, then that means that somebody has got to decide that this issue is important enough in the context of other competing issues to get it up on that short list and have the work done and have a proposal ready to go, and to really get the wheels turning right off the bat in 1991.

Now in anticipation of that, we have held this series of hearings. This is the 11th hearing we have held that features you today. So we are laying the testimonial foundation to be able to act on precisely these questions. But if there is not a package, well crafted; if it is not offered on a very timely basis, if it is not given the priority of the sort I am talking about in the kinds of dynamics that we are likely to see in 1991 and 1992, I can see how this issue can just remain unresolved.

And so I would hope to hear from you, and to see from you and others who have a strong interest in this, efforts and comments and a process that might well produce a package that is specific, that is well-crafted, that is timely, that is on the short list, and that this is one of the things that is seen as a priority and will be enacted in 1991; not 1992 or 2006 or 2010 or in some future year, but to set ourselves on a course to get it done from A to Z, with a signed bill for the President to put his signature on in calendar year 1991.

Now, that's a tall order but, in my view, that ought to be the goal. If the White House doesn't decide very quickly that that's how they feel about it and want to set the priorities in that way, I think it's not something that can happen by itself. There are just too many reasons why that set of issues is hard to work through, absent a driving top priority, you know, I don't say the single highest priority, but in that top tier set of priorities where the administration says, this is one thing we're going to get done now, and in that legislative window.

I say that to you because you bring a serious interest and as keen a knowledge in these subjects as anybody. And I think now that has to be blended with a sense as to what should our timing and what kind of goals should we be setting in terms of actually getting it done. So I hope you'll reflect on that, and if you think that that's something that ought to be on that short list, and that we ought to try to get it done in that timeframe, I think it's important that you act accordingly.

Chairman **Breeden**. Well, Senator, I would first like to again express my agreement with you that these are important issues. We have an extraordinarily strong, and in many respects, an extraordinarily successful financial services industry in this country. At stake are over 5 million jobs, anywhere from 5 to 15 percent of the gross national product in the United States, depending on what you count in in financial services. And this is a terribly important sector of our economy in its own right.

However, it happens to be a sector that also has a very big impact on the cost of capital for every other business in America. And oftentimes we get caught up in the debates of what's good for the banks and what's good for the brokers. And I think, as I tried to indicate at the outset, that isn't the right question. What's good for the people who save and invest in this country? That's the question. What's good for the people who have a new idea and want to invest in R&D or invest in bringing a new idea to market, and open up a new plant and new equipment and create jobs. That's what's important.

The **Chairman**. You and I agree on that.

Chairman **Breeden**. And I think we agree on that, and I think we also agree, as I know Senator Garn, Senator Heinz, Senator Dodd, and a wide spectrum of the membership of this committee agree that we can do better than what we are now doing. There are some weaknesses there. There are areas where we have costs we don't need. There are restrictions on competition.

The **Chairman**. If I may stop you. It's late in the day and you've been very patient. All that's been said more than once.

I think the bottom line is, do we need a major legislative package, will it be teed up in terms of having that brought forward in a comprehensive way, early in time next year, so that we've got a real chance of getting it done. That's the issue.

I mean, we can talk about it forever. The question is, are we ready to do something about it?

Chairman **Breeden**. I think that is the question. And I was just trying to suggest that a great deal is going on. We certainly put a lot of effort in this testimony and trying to suggest some critical factors that we think need to go into the building of a specific package. We all agree something needs to be done. The question is what.

We've tried to lay out some things we think are terribly important to be included in that process, and the hearings you're holding, I think, have been very important in laying the groundwork. We've got to do our homework before we just slap a package together. It would be all too easy to send up a bill and announce it's a high priority. But if it isn't a good bill, it isn't going to pass and shouldn't pass.

The CHAIRMAN. Yes. Well, no one's suggesting that. But I'll tell you something, if we don't have something that's tangible, concrete and solid, that comes very early, either late this year in advance of next year, or very early in 1991, then I think those of us that would like to see something done are going to find it very hard to get it done. And this has to be something the President wants. It has to be one of his driving priorities. And if it is, you know, then that really strengthens our ability to get it done. If it's something that's off to the side, you know, where there's no great interest, it's not seen as a key priority, it becomes very difficult to get it done. Meanwhile, the rest of the world's moving ahead at a very rapid rate. And that concerns me a great deal.

Let me just ask you one other thing. And that is, generally your approach for dealing with holding companies with numerous subsidiaries depends on coordination and cooperation among the regulators. Yet, as you know last week, Treasury Secretary Brady testified in his view the jurisdiction of the stock index futures, which we've talked about other times this morning, should be moved from the CFTC to the SEC, because the two agencies have had some difficulty in coordinating their activities. If we're going to run into that kind of a problem there, how can we rely on regulatory coordination among the following, because this is who is and would be in the act. You'd have the Federal Reserve, the OTS, the FDIC, the OCC, the SEC, CFTC, the Treasury, 50 State banks, thrift and securities and insurance regulators. I mean, if we're going to rely on coordination and good will among all of these, if you will, bureaucratic entities, each of which has a piece of the job to do, I mean, you've got an army of people with different marching orders, different responsibilities for different parts of this oversight job and supervision. Sometimes these things overlap, sometimes they I think they end up probably even leaving gaps where somebody thinks somebody else is in charge, and maybe nobody's in charge.

Is it realistic to imagine that we're going to get what we need in this kind of complex and sophisticated age if we simply say, OK, all you folks out there that are doing a piece of this job, you just keep doing it and you work together, and we can have confidence that we'll get a good aggregate outcome?

Chairman BREEDEN. Well, I don't think we've proposed exactly that the system rest on coordination. I indicated that, as important as it is today, there's a lot of coordination that occurs today and that would be important under any system, unless you created a giant ministry of finance that had all the regulators consolidated within it. That's one option. You could——

The CHAIRMAN. Why shouldn't we do that?

Chairman BREEDEN. Well, it's certainly an option, one way to produce coordination. And for example, in the commodities and stock area, that's what most countries typically do. They put them both under a——

The CHAIRMAN. Well, you're arguing for that. You're arguing for us to do that. But I'm wondering, given the size, scale and scope of these issues and the fact of the speed of technological change, the transactional activity and everything else, should we perhaps be thinking of some kind of an over-arching way of collecting all of this sort of diverse army of separate regulatory and supervisory bodies into some kind of a coherent sort of control operation?

Chairman **Breeden**. It gets down to a question of approach, I suppose, as to whether you're going to have a regulatory system that's top down or bottom up. And you can say that there must be an agency out there. Let's imagine that in our future, we——

The **Chairman**. We hope that doesn't go bottoms up. I mean, you know, we want one that doesn't capsize.

Chairman **Breeden**. We want the same thing there. Except, looking at bank holding company regulation. We have a system in which there is this philosophy; there must be a regulator at the top. Last year there were over 200 bank failures. Although we have a holding company regulator, we've had hundreds and hundreds and hundreds of failures. We had holding company regulation in the S&L's, too.

So, having an agency that is charged with overseeing the corporate entity that owns the stock of an operating subsidiary does not guarantee you're not going to have failures.

The **Chairman**. I agree with you. But who adds all this up? I mean, it seems to me that, after a while, you start to run into a situation where common sense says to you, not that you have a single czar, but that you've got some kind of a coordinating mechanism, some kind of a—you know, we do it every other place. Why, in a situation here, where we're at the same time recommending some rather sweeping new changes, why wouldn't we want to make awfully sure that we have coordination nailed down in a way where somebody's accountable for it, somebody's responsible for it, we have a way of measuring it much more carefully as to whether in fact it is or is not happening, rather than to leave it to a disparate army of people who do bits and pieces and hope that they like each other and that they have the time and the good will to share information and so forth?

Chairman **Breeden**. I don't think you can rest it on that. And I wouldn't ever suggest that. I think there are some things that can be done to try and improve coordination. Certainly, for example, Congress created the Federal Financial Institutions Examination Council, the FFIEC. We don't sit on that group. Perhaps we ought to participate in that group.

There are different kinds of councils of regulators, colleges of regulators. Maybe we need a college of regulators, where all the agencies who are involved in supervision meet regularly to discuss approaches to common problems. What I'm trying to suggest may be somewhat counterintuitive, but having seen these problems when the rubber hits the road, I also think it's the best way to approach them. If you think of making it possible for companies to have subsidiaries, in banking, securities, insurance, real estate, and commodities, there is no single agency that can bring it all together and knows about all those things.

What we have to recognize is that there is a reason we regulate banks, and we ought to regulate each and every bank with the same intensity, with the same unswerving dedication to imposing capital requirements, accounting standards, prudential standards, even if in one case, that bank may have an individual that owns it or in another case, the bank may have 500 public shareholders, and in a third case, the bank might be owned by a corporate parent. But all those banks ought to be regulated the same way by a bank regulator. If anyone, whether it's a single individual that owns that bank or a corporate parent, tries to take capital upstream, there has got to be a regulator standing there that says, no you can't. And the same thing with an insurance company or with a broker dealer.

What I'm trying to say is that we should regulate these companies to protect the public customers or to protect deposit insurance, and the people charged with doing that are at the actual operating level, where the companies are taking the risk. That's where we need to focus the regulation and make sure that, in each case, the plug can be pulled at the appropriate time by the regulator who's closest to the scene.

The CHAIRMAN. Let me give you an idea, just as we finish here, and that's this. I think if we're going to march into the brave new world of financial modernization, and we're going to change the boundary lines, and we're going to allow new kinds of cross affiliations with various kinds of firewalls and so forth, and there's going to be a rather sweeping series of changes put in place, I think for the same reason there's an RTC Oversight Board named in that instance, that we ought to have, at least for a period of time, if not in perpetuity, some kind of way in which the top people responsible for these major functional areas have to work as a unit. And, frankly, the lack of the ability to work as a unit between the SEC and the CFTC is a single example that very powerfully makes the point that I'm making. And I could pick other examples.

And I'm not saying that there isn't an intention and a desire to want to work together, but there are reasons why, sometimes, no matter how hard anybody tries, that that process just doesn't work very well. And I don't want to get back off into that subject here.

But in the instance of implementing a new system for the future, I think it's very important that major people responsible for major core sections have some formal way of sitting down together and working together for the common good; not for their agency and not to figure out a way to elbow the other agency. I'm not saying that you would do that, but that tends to happen. I mean, there's this bureaucratic infighting that goes on in any set of organizations. I think that to get people in an organized setting with accountability and responsibility to have to see each other, talk to each other, resolve these conflicts, also sends a very important message down the ranks into the next tiers of people who otherwise can become very much turf conscious, and you don't get the kinds of dynamics across this functional regulation checkerboard that perhaps you ought to have.

So I'd urge you to think about that because I think, when we make these changes, we've got to make very sure that they're working properly and being implemented properly. We have an oversight responsibility in that way, and we'll take it very seriously. But on the day to day operation, in making sure that we really get a collected effort in a unified, sort of top down direction, in terms of the way this thing has to function in a cooperative way, and make sure there are no gaps, and that we minimize the overlaps, I just think has to be part of it.

Chairman **Breeden**. I agree with you. And I don't think you can have too much coordination. We participate very actively in the President's Working Group and a number of other groups, which try and bring together the regulators. I talk to my colleagues on a daily basis. I really think that both, formally and informally, we all have to remember that we work for the same people, the American public. Whether we're running a securities agency or a commodities agency or a banking agency, we work for the same 250 million people. I think that is important, and Congress can sometimes usefully encourage that kind of cooperation.

Just as a footnote, in the CFTC, there are some times areas where the law doesn't permit cooperation. An agency can't always just agree by what its colleagues say by majority vote. The statute has to also permit that.

But your point about the importance of consensus and coordination and cooperation is an excellent one. I agree with it. I think that is generally the spirit that does prevail among the regulators. I think we all are acutely aware of the common problems we face, and try every day to work together pulling the oars in generally the same direction. And I think that's got to be a part of the current system, and it's got to be a part of any future system.

The **Chairman**. Thank you very much.

[Whereupon, at 12:49 p.m., the hearing was concluded.]

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

WEDNESDAY, JULY 25, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Garn, Heinz, D'Amato, Bond, Dixon, Sanford, and Graham.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The **Chairman**. Let me just indicate to all those who are gathered that we'll be a little late in starting. The Secretary called earlier this morning to indicate that he would be meeting with the President and the Congressional leaders at today's budget summit meeting.

It was his hope that this particular meeting this morning might be a productive one and, in any case, he would have to play his part in that meeting and he would endeavour to arrive as close to 10:00 as possible, but that he might very well run somewhat past that depending upon how the meeting, the budget summit, was going.

I assume that the longer it is that it takes him to arrive, the more hopeful a sign it may be that we're having progress on the summit. But, in any case, I would expect he will arrive at any time. We have not had a notification specifically from him in the last immediate time period. So we'll await his arrival and expect him to be with us shortly.

So I just wanted everybody to know what the circumstances were.

[Pause.]

The **Chairman**. Let me just indicate that we've been told the Secretary has left the White House some minutes ago and is on his way here and will be here shortly. I would anticipate probably within 5 minutes or so, we'll be starting.

[Pause.]

The **Chairman**. The committee will come to order. We certainly welcome the Treasury Secretary this morning. We're all looking for a facial expression that might tell us how the budget summit went this morning.

Could you give us a one-line sentence for any progress today?

Secretary **Brady**. I would characterize the meeting as being one of great good will. [Laughter.]

The **Chairman**. That's no small feat in this town. I would say that's a very important report.

The committee is very pleased to have the Treasury Secretary here this morning. He appears as our twelfth witness in a series of thirteen hearings the committee has been holding over the course of this year on deposit insurance reform and financial modernization. Included in this long series of hearings that have been underway now were two that we held in June where we heard from top management officials from Barclays Bank of England, The Fuji Bank of Japan, the Deutsche Bank of Germany, and Canada's Bank of Montreal, along with other international banking experts.

Those two hearings and the one we're holding today are designed to give the committee a better understanding of financial services developments and trends, and other major financial centers and their potential impact on the competitiveness of U.S. financial institutions, both overseas and right here at home in our own domestic market.

In May, when Gerald Corrigan, President of Federal Reserve Bank of New York, appeared here, he urged this committee to formulate legislation to reduce the product and geographic restrictions that are now placed on our banks so that they are in a stronger position, in his view, to compete here at home and overseas. In doing so, he stated this to us; he said:

> The U.S. banking system is simply out of step with the rest of the world. More importantly, it is out of step with the realities of the marketplace.

So I very much look forward to Secretary Brady's reaction today to that particular statement by President Corrigan of the New York Federal Reserve Bank.

Last January, Mr. Secretary, when Senator Garn and I wrote to you and asked you to testify we asked that you address the following issues: one, whether the European Community plan to give its banking institutions universal banking privileges throughout the European Community by the year 1992, how that will impact on the ability of our U.S. banks to compete effectively in Europe and result in European banks becoming even stronger competitors here in the United States.

Second, we asked whether the manner in which the Japanese regulate their banking and securities markets gives their institutions competitive advantages over foreign firms within the country of Japan, as well as in their operations overseas and particularly here in the United States, and, if so, how we might address that kind of a gap problem.

Third, we asked whether the manner in which we regulate our financial institutions has a negative impact on the competitiveness of both the financial and non-financial parts of American industry. Then, finally, what changes does the Treasury recommend in our laws regulating financial institutions.

In sum, what the committee is hoping to develop and wants to hear from you is what steps, if any, the administration believes the United States should be taking to make our financial services institutions more competitive in what is this very rapidly developing global market. And just as important as what those steps might be, when it would be that they should be taken.

I just want to say one other thought or two on the personal side. I think you've given us an excellent statement today and I know there are enormous demands on your time and your closest working associates with the budget summit and international activities and stock market questions and a host of other things. And I want to say that I appreciate particularly the quality of this presentation today in the midst of all of the other competing efforts. I think, it's well-focused and contains a lot of very useful information.

The other thought I want to say is this. That is that if the conclusion is reached that we have, in a sense, a developing consensus that the time is upon us to undergo a modernization of our financial system and to change it in ways that make it more competitive and better able to deal with these new global realities and deal with deposit insurance reform as part of that, it's my own view now, after having eleven of these hearings prior to today, that we should really plan to get that issue addressed and completed in calendar year 1991.

And I say that because we tend to go, as you know, in 2 year election cycles, and we're just concluding one now in 1990. So the legislative window, if you will, is closing on the sort of broad, comprehensive legislation of this sort. But it would seem to me, and I've talked with colleagues on both sides of the aisle on this committee, that 1991 offers a new legislative window and that if we can work together to have a package that we can develop and move on early in the year, if it's seen as a top priority—not necessarily the top priority, but one of maybe 4 or 5 major legislative goals for the administration in calendar year 1991—that working together, we ought to be able to take and address what are very complex structural issues and regulatory issues and get them resolved in a way that would give us a good result, so that the United States could move into the 1992 period with Europe 1992 and other international developments on a much stronger financial competitive footing.

So I would be interested as well today in your reactions as to those kinds of thoughts about timing here. Because I think if we decide among ourselves, the administration and the Congress together, to work cooperatively as we have on other items, there may be an opportunity here that would let us do this very important work starting either late this year or very early next year.

So, with that, Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **GARN**. Thank you, Mr. Chairman. First of all, let me say that I completely agree with your last statements about the need to move legislation in 1991 and try to take advantage of it not being an election year. As one who gave his first speech on the need to modernize our financial structure in 1975, I think 1991 would be a good time to start on that process.

In his prepared remarks this morning, Treasury Secretary Brady notes that financial restructuring is inextricably linked to deposit insurance reform. And I certainly agree. We cannot separate the two. At the same time, while I recognize that the Treasury is not yet ready with its recommendations on the issue of deposit insurance reform, I also think it is most important that we continue committee hearings on how our current laws relating to financial structure are interfacing with the evolving financial marketplace.

Again, I applaud Chairman Riegle for continuing that effort this year. If we did not continue with these hearings, I fear that the current misconceptions about the role of Federal Government deregulation in the S&L crisis would so poison the atmosphere for financial restructuring that Congress would once again find itself paralyzed. Such an outcome would seriously disadvantage our nation's financial institutions, undermine the relative position of our financial markets in world competition, weaken our economy, and, in sum, greatly compound the ultimate costs traceable to the S&L crisis.

Any politician who dares to call for financial restructuring to help our nation's financial institutions compete in the changing international marketplace runs the risk of being accused of having failed to learn the lesson of deregulation of the thrift industry. The lesson was not that we should ignore it, I repeat. The lesson is not that we should ignore the impact on our financial institutions of having to compete in today's marketplace using organizational structures dictated by laws that were passed more than 30 to 50 years ago.

Hopefully hearings like today's will help dispel that notion. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Garn.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I'm going to ask that my statement be included in the record as if read in its entirety.

The CHAIRMAN. Without objection, so ordered.

Senator D'AMATO. Let me say that any modernization of the financial services industry must ensure that that system is fair, is competitive, and above all, as the Secretary has mentioned in his prepared testimony, that the taxpayers are not placed at risk so that if we have a riverboat gambler operation, it will not be with taxpayers' dollars. I think that is absolutely paramount.

And certainly the lesson of the thrift debacle, I commend the Secretary for making note of that, and I hope in our legislative deliberations we'll be able to come up with legislation that handles those 3 points: competitiveness, fairness, and also ensuring that taxpayers' dollars will not be placed at risk in new and venturesome activities.

I think, Mr. Chairman, in previous hearings when you had some of the foreign bankers come in, they testified to the point that their Government does not underwrite any of these activities. So, while they have integrated economic activities, it is the stockholder, the shareholder, not the taxpayer, who is part of this risk venture. That is part of our capitalist system, and I think we've got to ensure that that's the case.

[The complete prepared statement of Senator D'Amato follows:]

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, today the committee continues its consideration of financial services modernization. I join you in welcoming the distinguished Secretary of the Treasury, Nicholas F. Brady. Secretary Brady has been deeply involved in recent analyses and proposals regarding the stock market, the economy, and the future of the financial services industry.

For example, before he joined the President's Cabinet, Secretary Brady was the Chairman of the Presidential Task Force on Market Mechanisms, which analyzed the October 1987 market disruption and issued an informative report on why the severe drop in the market happened and what can be done to prevent it from happening again. Since he joined the Treasury Department, Secretary Brady has supervised the development of many important reports and proposals regarding the financial services industry.

Mr. Chairman, recent events have again focused our attention on rapid stock price changes. Just yesterday, the front page of the Washington Post and other papers reported a 108 point drop in the stock market during a short period. Fortunately, this drop was followed by an increase in stock prices, although the market still fell by 56 points for the day. While not critical, this event reminds us that the market is still very volatile, and that until the market settles down, the individual investors who are so important to our economy and to our capital formation process will stay out of the market.

In addition, several reports have indicated that computerized program trading and index futures and options were involved in the sharp sell-off. These issues need to be explored by this committee as we consider how to improve our financial services industry.

Dramatic changes in both the domestic and international financial environments have brought us to a point where it is no longer relevant to discuss whether we should undertake major reform of the legal structure of the financial services industry. These changes make reform imperative.

As Chairman Breeden's testimony the other day indicated, international developments have created a highly competitive market for American firms. The innovation of financial products and the globalization of financial services continue at a rapid pace. Reform to our financial system is necessary to respond to these competitive pressures. The question is how do we go about it.

Over the last few years, I have come a long way on the issue of making structural changes to the financial system. I have done this because I recognize that it is necessary to allow financial diversification in today's turbulent and competitive economic environment. This is one of the lessons of the problems of the savings and loan industry.

However, another lesson from the savings and loan debacle is that we must design reform that will protect the taxpayer sufficiently from any possibility of a Federal bailout. Financial institutions should be able to engage in broader, more comprehensive activities, but they should do it with their own money at risk, not the government's.

Finally, provided that these concerns are met, any modernization of the financial services industry must ensure that the new system is competitive and fair. I look forward to Secretary Brady's testimony on these issues.

The CHAIRMAN. Thank you very much. Senator Bond?

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman. I will join in welcoming Secretary Brady and would second the Chairman's statement about what an excellent presentation you have provided for us, Mr. Secretary. Having had some inkling that perhaps there were other things on your mind in the last few days and that there was not a great deal of time to work on this, I imagine it must have been a very short night for you.

You have stated what, I think, is the very compelling reality. On page 11, you say with ongoing changes in the marketplace, the system has outgrown its historical regulatory structure and retaining the status quo is not an attractive option. I think it's extremely important that we begin work on this whole question.

Now I would share with you and the members of the committee a piece of advice I picked up visiting one of the international bankers who so frequently come and provide us the benefits of their views and follow with a great deal of interest what we're doing here. That banker noted that Under Secretary Mulford had been able to suggest to the Japanese certain changes, and with a wry smile he said, "It's amazing to me that they have not suggested major changes to you." When I asked him what the major changes would be, he said, "Like getting rid of the McFadden and, I assume, the Douglas Amendment, as well," several other things that I think you refer to in here.

So we're getting lots of good advice from abroad. We look forward to hearing your analysis of the situation and to working with you next year as we try to bring the regulatory structure up to date with what's going on in the marketplace.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Let me say one other thing, Mr. Secretary, and that is the Budget Committee is meeting this morning. Senator Sasser, of course, of this committee serves as chairman of that committee. Many of us on this committee are members of the Budget Committee. We're marking up this morning some budget reform proposals upstairs on the sixth floor.

We're not allowed to vote by proxy in the Budget Committee. We have to be present to vote. So a number of our members are there and will be coming back and forth in the course of the mark-up process in the Budget Committee.

But we'd be pleased to hear from you now. We'll make your full statement a part of the record, and we'd like to hear your remarks at this time.

STATEMENT OF NICHOLAS F. BRADY, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary **Brady**. Thank you, Chairman Riegle, Senator Garn, members of the committee. I appreciate being invited to discuss the modernization of financial services regulation in this country, especially in light of increased international competition for U.S. financial firms and markets.

The Treasury Department shares this committee's concern about the international competitiveness of our financial firms. As you know, financial systems are undergoing dramatic changes abroad, especially in Europe as part of EC 1992. The trend in the industrialized countries is clearly to explore the expansion of financial services firms as a means of strengthening the competitiveness of financial institutions. While ours is still the most innovative financial industry in the world, we are looking over our shoulder and finding our competitors closing the gap.

At the same time, we are deeply concerned about the relationship of financial services activities to deposit insurance and other aspects of the so-called "federal safety net" that applies to depository institutions. Obviously, this relationship is particularly critical in view of the cost of making good on deposits in failed thrifts. As a result, we have added this crucial issue to the Treasury's comprehensive study of deposit insurance mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

As you are well aware, this study is not due until February 9, 1991, although we intend to complete it by the end of this year in line with some of the thoughts Chairman Riegle has expressed here this morning. As the committee is aware, the project involves the cooperation and labors of all of the relevant Federal banking agencies, including the Federal Reserve Board, the Comptroller of the Currency, the Office of Thrift Supervision, the FDIC, the National Credit Union Administration, and the Office of Management and Budget.

Because we are now deeply involved in the study, it would not make sense today to offer specific proposals for change. In fact, much of this testimony is necessarily descriptive rather than conclusive. Those who are hoping for an advance preview of Treasury's study may, therefore, be unsatisfied.

And I appreciate the Chairman and other members understanding that this presents us with a problem. As I have said, we expect to complete the study by year end and will be presenting its conclusions and any legislative recommendations early in the next Congress.

Nevertheless, I assure you that, with the thrift experience so fresh in mind, we will not propose changes to the financial services regulatory structure that would increase the taxpayers' exposure. But we must also bear in mind the relationship between competitiveness and profitability on the one hand, and safety and soundness on the other. A system that produces institutions that are less profitable and less competitive is inherently unsafe and unsound in the long run.

And if you conclude that our banking system is indeed becoming less profitable and less competitive, and therefore less safe, then retaining the status quo is not an attractive option. Simply put, the task is to enhance competitiveness while decreasing taxpayer exposure.

My statement today will compare our financial services regulation in the United States to developments in Europe and Japan, setting forth several guiding principles that we think should apply to any proposal for change in the United States. Let me begin by briefly describing the State of the U.S. banking industry, which has changed dramatically in the last two decades.

First, the benefits of the traditional banking franchise have been significantly eroded. Interest rate controls are gone, as is the ability to avoid interest payments on transaction accounts. More important, technology and changing markets have eaten directly into the traditional banking business on both sides of the balance sheet.

On the liability side, money market funds with credit card and check writing privileges now compete directly with the traditional bank deposits. In addition, thrifts and credit unions now offer accounts and services that are often indistinguishable from those offered in commercial banks.

On the asset side, many of the bank's most credit worthy loan customers, including blue chip corporations, now borrow directly from investors in the commercial paper market at lower rates. This competition for traditional bank business has produced substantial benefits for the consumer, including lower borrowing rates and more choice and flexibility. But it has also diminished the franchise value on which the banking system was built.

How have banks responded? Many banks have found their lending concentrated in riskier lending activities due to the erosion of their more traditional lending business. These riskier activities have included loans to less developed countries, greater commercial real-estate lending, regionally concentrated energy and agricultural loans, and loans in highly leveraged transactions. This committee is well aware of the problems associated with these activities, including the potential for reduced earnings and higher provisions for loan losses.

On the positive side, U.S. banks have been innovative in developing businesses in which they have regulatory freedom. For example, bank credit cards and automatic teller machines have revolutionized banking for the convenience and the benefit of the American consumer. Moreover, in response to the erosion of the traditional corporate lending business, banks have expanded into fee generating businesses like mortgage banking and financial advisory work.

But as the traditional banking business has grown less attractive, banks have also sought to expand into businesses in which they were prohibited or "protected" from competing, including securities, insurance, and other financial services. At the same time, diversified financial companies have aggressively sought to expand into the most attractive banking lines of business in order to provide the full range of financial products and services demanded by their customers.

Despite statutory and regulatory impediments, these efforts to expand into new lines of business have succeeded in part. A limited degree of statutory change, particularly at the state level, combined with regulatory and judicial interpretations of existing law, has produced a new patchwork quilt of rules and exceptions. This new "system" allows some new financial activities and limited geographic expansion, as described in my written statement.

Stepping back, then, how do we generally view the competitiveness of the United States banking business? We see it as a system that, through ongoing changes in the marketplace, appears to have outgrown its historical regulatory structure. The result is overcapacity, layers of regulation, concentration in the riskier parts of traditional commercial lending, uneven product diversification with rules and exceptions that sometimes make little sense, and inefficient limitations on geographical diversification.

Let me now turn to the important changes taking place in the global financial services market. As you suggested in your letter of invitation, I will focus my remarks on developments in Europe and Japan and their impact on United States firms and markets.

The Treasury Department strongly supports the European Community's objective of economic liberalization. The EC's efforts toward the eventual goal of economic and monetary union have significant implications for the United States and world economies. In the financial services area, the Second Banking Directive will take effect on January 1, 1993. This directive will allow EC banks to engage in activities associated in the United States with commercial and investment banking. It will be possible for any bank established in the EC to offer a full range of services—sometimes referred to as "universal banking"—throughout the entire European Community.

Whether U.S. firms will be able to compete successfully in the new environment is difficult to predict. European banks that operate under a variety of constraints in different markets will be able to consolidate and focus their strategies. At the same time, it will be more difficult for U.S. firms to compete on foreign turf when they cannot provide the same services at home, because the knowledge and expertise developed at home will be a crucial foundation to gaining market share abroad.

Let me now briefly summarize developments in Japan. The Japanese have been moving incrementally for several years to liberalize and modernize their financial regulatory structure. They invariably describe their approach as "step-by-step." Financial services in Japan are highly compartmentalized—far beyond what we have in the United States under the Glass-Steagall approach. In addition, regulation is burdensome, ad hoc, and unpredictable, particularly for newcomers and outsiders.

There has been some progress in liberalizing and opening Japanese financial markets. However, the pace of change on the whole has been slow and the process of liberalization is not yet complete. Treasury has worked consistently and vigorously in the United States-Japan Working Group on Financial Markets to accelerate this pace of change.

The Japanese Ministry of Finance has been reconsidering the Japanese equivalent of Glass-Steagall—embodied in article 65 of the Japanese Securities Exchange Law. In various advisory groups representing the banks and the securities industry, the Japanese are debating financial deregulation. Rivalries between the banking and securities industries are intense, however, and deregulatory steps are frequently a compromise among financial players and regulators.

In short, the improvement in the international position of Japanese banks has occurred in spite of a relatively inefficient and burdensome regulatory structure.

Stepping back, it seems to me that there are lessons to be learned from both the EC and Japan. In the EC, we see a strong trend toward financial modernization which appears to lead in the direction of EC-wide universal banking. This process of reform forces us to face up to the inadequacies of our own regulatory system if we hope to keep pace in the 1990's.

By contrast, despite the beginnings of change, the Japanese regulatory structure does not appear to offer the United States an attractive model for reform. Rather, the well-reported success of Japanese banks is a function of interest rate controls, a national policy of treating banks as an important competitive asset, the trade surplus, and a high savings rate.

In light of the developments described above, how do we find our banks faring against their international competitors? The competitive position of U.S. commercial banks in global markets today can be measured in different ways. But, by many measures, we are losing market share and competitive standing, both at home and abroad. On the positive side, in some areas our banks continue to innovate and to develop new products and services such as financial advisory services, interest rate swaps and various consumer banking products.

There are a variety of causes we could point to in explaining the relative decline in our banks in the past decade. The structural rigidities of our system are no doubt partly at fault. However, other factors must be cited: the U.S. balance of payments deficit, the relatively low personal savings rate, the relatively high cost of capital and the trend toward disintermediation in the U.S. market.

As I mentioned at the outset, it is impossible to develop specific recommendations for change in the U.S. system without considering their broader relationship to deposit insurance and other elements of the Federal safety net. Fundamental structural issues that must be addressed in financial institutions reform include the appropriate relationship between banking and other financial services, between banking and commerce, the extent and usefulness of firewalls and the extent to which consolidated supervision is necessary, all of which are interrelated.

These and other structural issues will be addressed in our study of deposit insurance. Nevertheless, it is possible to make some general observations and identify several guiding considerations.

The overall considerations in recommending any changes to the regulation of financial services must include: First, the competitiveness of U.S. financial firms and markets; second, the exposure of the taxpayer through the Federal safety net; and third, the stability of the financial system. Some have argued that the first consideration conflicts with the other two, that enhanced competitiveness through broader powers will automatically increase the exposure of the taxpayer and destabilize the system.

But is this necessarily so? U.S. banking organizations are losing traditional businesses to new technologies and new markets, yet they are not permitted to fully adapt to new lines of business. The result has been concentration in the riskiest lines of business. Properly supervised diversification into other financial activities could contribute to greater profitability, diversified risk and a stronger capital base.

More important, it may be possible to insulate the federal safety net from the increased risk created by new activities. The fact is that every developed country has some form of broad safety net for its financial firms, yet most countries permit their firms to engage in broader financial activities than we do. At the same time, there have been few substantial losses to their systems, and none anywhere near the magnitude of our thrift losses.

The challenge, then, is to devise reforms that will reduce or contain the risk to the taxpayer while at the same time increasing the long-term stability and competitiveness of our financial firms. With that general background, it seems to me that there are a number of important principles that ought to be embraced in any future recommendation for change.

The first is capital. Broader activities for banking organizations ought to be linked to strong capital requirements, preferably risk-based. We learned all too painfully from the thrift crisis that a crucial protection for the taxpayer is requiring firms to have a substantial amount of their own money at risk to absorb losses.

This Administration has consistently insisted on prudent capital requirements for financial firms, whether they are thrifts or Government-sponsored enterprises. To attract sufficient capital, banks must be profitable. Thus, any regulatory reform must be undertaken with a view to enhancing the profitability of our system.

Second, uniform regulation: our system of regulation has become a gerry-built structure of rules and exceptions. Whatever direct or indirect activities are authorized for banking organizations, they ought to be authorized on an equal basis for comparable institutions. We need rational regulations consistently applied.

Third, functional regulation: the Treasury Department has long supported the concept that the primary regulation of financial activities should be by function rather than by institution. In general, we believe that a firm's securities activities should be regulated by the SEC, it's banking activities by the banking regulators, its insurance activities by State insurance authorities, and so on.

Fourth, a better organized regulatory and supervisory structure: we now have three Federal bank regulators, one thrift regulator, one credit union regulator, and 50 State regulators. Regulations and regulatory responsibilities are often overlapping and duplicative. The banking supervisory structures of most of our major competitors are, by contrast, more unified and more coherent. As we explore the reform of our financial institutions, we will also need to explore the reform of our regulatory structure—although, to be frank, the inevitable turf fights involved may prevent the full achievement of this goal.

Fifth, efficient geographic diversification: interstate banking permits banks to diversify and avoid being too closely tied to the vicissitudes of local economies. Any reform proposal should carefully examine the concept of permitting market participants to establish interstate branches.

Sixth, let me briefly discuss the question of the appropriate structure of financial firms that have access to the safety net. It is difficult to imagine the German-style universal bank structure with our current system of deposit insurance. In evaluating the holding company and subsidiary models for separating banking and non-banking activities, we should start from the premise that bank participants should decide the appropriate structures for their own organizations depending on their own particular circumstances, so long as this does not create supervisory problems.

Finally, the issue of Glass-Steagall: the fact is that Glass-Steagall is no longer the rigid wall between banking and securities that it once was. Increasingly, firms engage in both banking and securities, but under a set of rules and exceptions that is sometimes arbitrary and inefficient. These rules need to be rationalized on a fair basis.

Mr. Chairman, that concludes my remarks. I'll be glad to answer any questions you might have.

[The complete prepared statement of Nicholas F. Brady follows:]

TESTIMONY OF THE HONORABLE
NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

July 25, 1990

Chairman Riegle, Senator Garn, and Members of the Committee, thank you for inviting me to discuss the modernization of financial services regulation in this country, especially in light of increased international competition for U.S. financial firms and markets.

The Treasury Department shares this Committee's concern about the international competitiveness of our financial firms. As you know, financial systems are undergoing dramatic changes abroad, especially in Europe as part of EC 1992. The trend in the industrialized countries is clearly to explore the expansion and diversification of financial services firms as a means of benefitting wholesale and retail consumers and strengthening the competitiveness of financial institutions. While ours is still the most innovative financial industry in the world, we are looking over our shoulder more and finding our competitors closing the gap.

At the same time, we are deeply concerned about the relationship of financial services activities to deposit insurance and other aspects of the so-called "federal safety net" that applies to depository institutions. Obviously, this relationship is particularly critical in view of the cost of making good on deposits in failed thrifts. As a result, we have added this crucial issue to the Treasury's comprehensive study of deposit insurance mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

This study is not due until February 9, 1991, although we intend to complete it by the end of this year. As the Committee is aware, the project involves the cooperation and labors of all of the relevant federal banking agencies, including the Federal Reserve Board, the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of Management and Budget.

Because we are now deeply involved in the study, it would not make sense today to offer specific proposals for change. In fact, much of this testimony is necessarily descriptive rather than conclusive. Those who are hoping for an advance preview of Treasury's study may, therefore, be left unsatisfied. As I have said, we expect to complete the study by year end and will be presenting its conclusions and any legislative recommendations early in the next Congress.

Nevertheless, I assure you that, with the thrift experience so fresh in mind, we will not propose changes to the financial services regulatory structure that would increase the taxpayers' exposure. But we must also bear in mind the relationship between competitiveness and profitability on the one hand, and safety and soundness on the other. A system that produces institutions that are less profitable and less competitive is inherently unsafe and unsound in the long run. And if you conclude that our banking system is indeed becoming less profitable and less competitive, and therefore less safe, then retaining the status quo is not an attractive option. Simply put, the task is to enhance competitiveness while decreasing taxpayer exposure.

My statement today will set forth our current perspective on financial services regulation in the United States; briefly compare that to financial services regulation in Europe and Japan, particularly in light of recent developments; and set forth several guiding principles that we think should apply to any proposal for change in the United States.

I. Financial Services in the United States

This Committee has received countless pages of testimony about the disjointed nature of financial services regulation in this country. Nevertheless, I believe it is useful to summarize the current situation in order to underscore the importance of changes occurring in international markets.

A. The Traditional Banking Franchise

Through a series of laws passed beginning in the early 1900s, especially after the 1929 stock market crash and the ensuing wave of bank failures, the government succeeded in rigidly segmenting and protecting the business of commercial banking in the United States. Banks received a number of special benefits, including deposit insurance, interest rate controls, and a prohibition on the payment of interest on demand deposits. Even before the 1930s, banks had gained ready access to the Federal Reserve's discount window and payments system. All of this was a prescription for steady profitability in the banks' traditional activity of short-term commercial lending to businesses.

The flip side of this coin, of course, was heavy regulation and supervision as well as the numerous restrictions on bank activities. Banks were prohibited from engaging in anything but traditional banking activities, and there were strict limits on geographic expansion.

For example, banks were sharply restricted from engaging in securities activities by the Glass-Steagall Act of 1933, and the later Bank Holding Company Act of 1956 curtailed their ability to affiliate with firms engaged in insurance and commercial activities. Banks had limited branching rights within states and were prohibited from crossing state lines by state laws, the McFadden Act of 1927, and the Douglas Amendment to the Bank Holding Company Act. Moreover, the Home Owners Loan Act and the Federal Home Loan Bank Act gave special privileges to thrift institutions that allowed them to dominate the mortgage business.

In short, the banking franchise created by the government was protected, restricted and potentially quite profitable. While banks were prohibited from engaging in most non-banking activities, they were also sheltered from competition from firms engaged in such activities. In addition, because of limitations on interstate banking, our system produced thousands of small banks that prospered. And even though the system generated a complex web of state and federal regulation -- 50 state regulators and three federal regulators -- it afforded both stability and pluralism over a number of years.

B. The Erosion of the Franchise

In the last two decades, however, the picture has changed dramatically. First, the benefits and protections of a banking franchise have significantly eroded. Interest rate controls are gone, as is the ability to avoid interest payments on transaction accounts.

More important, technology and changing markets have eaten directly into the traditional banking business on both sides of the balance sheet. On the liability side, money market funds with credit card and check-writing privileges now compete directly with traditional bank deposits. Thrifts and credit unions now offer accounts and services that in many instances are indistinguishable from those offered in commercial banks. And securities firms sell bank certificates of deposit in brokerage offices around the country.

On the asset side, many of the banks' most creditworthy loan customers, including blue chip corporations, now borrow directly from investors in the commercial paper market at lower rates. In fact, in the past decade, commercial paper outstanding increased nearly fivefold, from $112 billion in 1979 to $525 billion in 1989, while total commercial and industrial loans only doubled, from $295 billion to $639 billion over the same period.

This competition for traditional bank business has produced substantial benefits for the consumer, including lower borrowing rates and more choice and flexibility. But it has also diminished the franchise value on which the banking system was built.

C. The Current Situation

How have banks responded? Many banks have found their lending concentrated in riskier lending activities due to the erosion of the traditional business of lending at attractive spreads to highly creditworthy customers. These riskier activities have included loans to less developed countries; greater commercial real estate lending; regionally concentrated energy and agricultural loans; and loans in highly leveraged transactions. This Committee is well aware of the problems associated with these activities, including the potential for reduced earnings and higher provisions for loan losses.

On the positive side, U.S. banks have been innovative in developing businesses in which they have regulatory freedom. For example, bank credit cards and automatic teller machines have revolutionized banking for the convenience and benefit of the American consumer. Moreover, in response to the erosion of the traditional corporate lending business, banks have expanded into fee generating businesses like mortgage banking and financial advisory work.

But as the traditional banking business has grown less attractive, banks have also sought to expand into businesses in which they were prohibited or "protected" from competing, including securities, insurance, and other financial services. At the same time, diversified financial companies have aggressively sought to expand into the most attractive banking lines of business in order to provide the full range of financial products and services demanded by their customers.

Despite statutory and regulatory impediments, these efforts to expand into new lines of business have succeeded in part. A limited degree of statutory change, particularly at the state level, combined with regulatory and judicial interpretations of existing law, has produced a new patchwork quilt of rules and exceptions. This new "system" allows some new activities and geographic expansion, as summarized below.

Securities Activities. Banks now have the ability to engage directly or indirectly in a broad range of securities activities, although with numerous restrictions. They can engage with few limits in the underwriting and dealing of U.S. government and agency securities, general obligation municipal bonds, agency-guaranteed mortgage-backed securities, and certain kinds of municipal revenue bonds. In addition, they may engage in private placement activities, discount and full service brokerage, and financial advisory services. A recent court decision has permitted banks to securitize loans that they have originated or purchased. Moreover, banks may serve as investment advisors to mutual funds.

Finally, through recent interpretations by the Federal Reserve of Section 20 of the Glass-Steagall Act, bank holding companies may establish non-bank subsidiaries that derive up to 10 percent of their revenue from a wide range of otherwise prohibited securities activities -- including the underwriting of corporate bonds and, at least in principle, corporate equities. However, strict "firewall" requirements have been established to limit transactions between the insured bank and its securities affiliate. In practice, the Section 20 affiliates only benefit the very largest banks, and only in a limited way because of the strict firewalls.

Insurance Activities. State legislatures in Delaware and California have recently granted much more authority to banks chartered in these states to engage in insurance activities. The courts have thus far upheld the general principle that bank holding companies -- including ones from outside the state -- can take advantage of state insurance authority through the purchase of a state bank. However, such insurance activities must be conducted within the acquired state bank or an operating subsidiary (as opposed to a holding company affiliate, where it would clearly be prohibited). In addition, a number of banking organizations have extensive insurance authority that has been grandfathered under amendments to the Bank Holding Company Act. Finally, recent legal and regulatory interpretations permit national banks to sell title insurance, municipal bond insurance, fixed rate annuities, and insurance nationwide from branches in towns of fewer than 5,000. And banks have been permitted for some time to sell credit-related insurance.

Affiliation with Commercial Firms. Through legal loopholes that have opened and closed over the years, commercial and diversified financial companies have acquired a significant number of banks, principally through the earlier "nonbank bank" exception to the Bank Holding Company Act. Likewise, commercial and diversified financial firms have long been permitted to acquire thrift institutions. The result is a number of major companies that own both banks and other financial and commercial concerns. These firms include Sears, American Express, Merrill Lynch, Household Financial, and a number of major insurance companies. However, these companies now have strict limits on the operations of their banks, and other commercial and financial companies have been prohibited from expanding into banking.

Geographic Expansion. The states have taken interstate banking into their own hands. With few developments at the federal level, a number of states formed regional compacts in which interstate banking was permitted. A number of these regional compacts include so-called "nationwide triggers" (as do certain individual states) which permit full interstate banking on a reciprocal basis after 1991. For example, California will move to full interstate banking at the beginning of next year.

Nevertheless, despite this clear trend, a number of states still restrict interstate banking, and in virtually all cases banks are prohibited from branching across state lines. This is true even if the costs of interstate branching would clearly be less than incorporating separate banks in separate states with separate capital structures and separate management. The result is a haphazard expansion of geographic opportunities, which includes numerous inefficiencies.

Stepping back, then, how do we generally view the competitiveness of the United States banking system? We see it as a system that, through ongoing changes in the marketplace, appears to have outgrown its historical regulatory structure. The result is overcapacity; layers of regulation; concentration in the riskier parts of traditional commercial lending; uneven product diversification, with rules and exceptions that sometimes make little sense; and inefficient limitations on geographical diversification.

II. Developments in Europe and Japan

Let me now turn to the important changes taking place in the global financial services market. As you suggested in your letter of invitation, I will focus my remarks on developments in Europe and Japan and their impact on United States firms and markets. Before doing so, however, let me clarify that today's discussion will not address in detail the degree of national treatment accorded U.S. firms in these foreign markets. Treasury Under Secretary Mulford has testified recently before both this Committee and the House Banking Committee on national treatment issues. Preparation of the 1990 National Treatment Study is underway, and we will submit our detailed report to you by December.

A. The Challenge of EC 1992

The Treasury Department strongly supports the European Community's objective of economic liberalization. The EC's efforts toward the eventual goal of economic and monetary union have significant implications for the United States and world economy. An Economic Policy Council (EPC) Working Group on European Monetary Reform and Financial Liberalization, chaired by the Treasury Department with participation from key agencies and advice from financial regulators, is reviewing the implications of these changes.

1. The "Single Passport" Program

The new EC program for financial services is based on the principle of "mutual recognition." Essential supervisory rules are harmonized among the member states, which agree to recognize each other's national laws, regulations, and supervisory practices that have not been harmonized.

Based on minimal harmonization of rules, a financial institution established in any member state may provide certain financial services through branches or across borders in any other country in the Community under the supervision of the home country. This entire process is often referred to as the "single passport."

The Second Banking Directive, which will take effect on January 1, 1993, will allow EC banks to engage in activities associated in the U.S. with commercial *and* investment banking. It will be possible for any bank established in the EC to offer a full range of services -- sometimes referred to as "universal banking" -- throughout the European Community.

2. **Impact on U.S. Firms**

The impact of EC developments on U.S. firms will depend, first, on the extent to which they are applied in the context of national treatment, and second, on the extent to which they affect the ability of U.S. firms to compete. The Second Banking Directive provides for reciprocal national treatment and effective market access. Because the U.S. offers EC banks national treatment, we believe U.S. banks will not be discriminated against by the EC in the present environment. Nevertheless, the European Commission has indicated that Glass-Steagall and interstate banking restrictions in the United States may be the subject of future negotiations. In addition, there is a grandfathering provision in the Second Banking Directive that guarantees national treatment for those U.S. banks that establish a European subsidiary prior to 1993.

Whether U.S. firms will be able to compete successfully is more difficult to predict. European banks that operate under a variety of constraints in different markets will be able to consolidate and focus their strategies. Those in the U.S. market will bring sharpened skills and improved products.

Moreover, let me mention one provision of U.S. law that may adversely affect the ability of our firms to compete in foreign markets. The Federal Reserve's Regulation K imposes strict

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It is difficult to imagine the German-style universal bank structure with our current system of deposit insurance. In evaluating the holding company and subsidiary models for separating banking and non-banking activities, we should start from the premise that market participants should decide the appropriate structure for their own organizations depending on their own particular circumstances, so long as this does not create supervisory problems.

8. Glass-Steagall. The fact is that Glass-Steagall is no longer the rigid wall between banking and securities that it once was. Increasingly, firms engage in both banking and securities, but under a set of rules and exceptions that is sometimes arbitrary and inefficient. These rules need to be rationalized.

9. Enforcement. There is no substitute in a market driven industry with strict fiduciary obligations for quality management of high integrity. Just as there should be ample shareholder capital at risk, so too must there be managers of integrity. I have said before during our difficult debates on FIRREA and I will say it again, civil and criminal violations will be prosecuted to the fullest extent of the law.

V. Conclusion

Mr. Chairman, that concludes my remarks. I am happy to answer any questions you may have.

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limits on the absolute and relative size of equity securities dealing, distribution and underwriting activities of overseas subsidiaries of U.S. banks. We welcome the Federal Reserve's recent proposal to expand the limits on equity activities abroad and will study carefully the proposed revisions.

Finally, let me make one other point. It will be more difficult for U.S. firms to compete on foreign turf when they cannot provide the same services at home, because the knowledge and expertise developed at home will be a crucial foundation to gaining market share abroad.

B. Developments in Japan

Let me now turn to developments in Japan. The Japanese have been moving incrementally for several years to liberalize and modernize their financial regulatory structure. They invariably describe their approach as "step by step." Financial services are highly compartmentalized -- far beyond what we have in the United States under the Glass-Steagall approach. In addition, regulation is burdensome, ad hoc, and not predictable, particularly for newcomers and outsiders.

There has been some progress in liberalizing and opening Japanese financial markets. However, the pace of change on the whole has been slow and the process of liberalization is not yet complete. Treasury has consistently and vigorously worked in the U.S.-Japan Working Group on Financial Markets to accelerate this pace of change.

The Japanese Ministry of Finance has been reconsidering the Japanese equivalent of Glass-Steagall -- embodied in Article 65 of the Japanese Securities Exchange Law. In various advisory groups representing the banks and the securities industry, the Japanese are debating financial deregulation. Rivalries between the banking and securities industries are intense, however, and deregulatory steps are frequently a compromise among financial players and regulators.

In short, the improvement in the international position of Japanese banks has occurred in spite of an inefficient and burdensome regulatory structure. The positive causes of this success include interest rate controls that affect the Japanese saver and provide lower cost funds, the inclination to regard banks as a major international competitive asset, a persistently high current account surplus and a high personal savings rate. These factors may help explain the increasing penetration of the U.S. banking market by Japanese banks, which now account for 11.8% of all U.S. banking assets, compared to 20.6% for all foreign banks in total.

You asked specific questions regarding the effect of Japanese regulation on foreign competition.

The manner in which the Japanese regulate their banking and securities markets gives their institutions competitive advantages over foreign firms. For example, interest rates on more than 40 percent of bank deposits -- mainly at the retail level -- are still regulated, and retail deposit taking is not easily available to foreign banks without extensive branch networks. As a result, Japanese banks active internationally gain a cost advantage, on a consolidated basis, to the extent they still fund themselves domestically with regulated deposits paying interest rates which are lower than would prevail in a free-market environment. Deregulation of interest rates and development of an attractive money market in Japan have been major issues in the U.S.-Japan Working Group on Financial Markets.

The regulatory regime also allows for "main bank" relationships between banks and non-financial firms. This pattern of cooperation between banks and businesses can also be found in other countries. Nevertheless, the extensive interrelationship among banks and non-financial firms is particularly dominant in Japan, and presents a difficult challenge to U.S. financial firms seeking Japanese corporate business in Japan and worldwide. These relationships, apart from other factors such as performance, contribute substantially to the success of Japanese financial institutions.

Finally, the Japanese regulatory system involves supervisory procedures, regulations, changes in policy and approval requirements that cannot be readily grasped and easily accessed in written documents. Foreign financial firms are particularly disadvantaged because the Japanese rely extensively on informal consultation with leading domestic financial firms. This is especially true when rules are changed, or new procedures are established. While information appears to flow freely among the domestic firms and the regulators, foreign firms have difficulty breaking into the dialogue.

In the face of these regulatory and structural difficulties, foreign penetration of the Japanese banking market has been low. For example, the foreign share of total deposits was only 0.8 percent, and of loans 1.7 percent in March 1989. In the securities industry, however, some U.S. investment banks have fared better, as market opening measures have allowed foreign firms, in a few areas, to exploit their expertise. These areas include the government debt market and derivative products. In other areas where foreign firms have considerable talent, such as pension fund and investment trust management, they are still effectively excluded. The introduction of innovative financial products has also been difficult.

III. Competitive Position of U.S. Banks

The discussion above demonstrates the contrasts and similarities between the structure and regulation of our financial services firms and the trends in the financial services industry abroad. It seems to me that there are lessons to be learned both from the EC and from Japan. In the EC, we see a strong trend toward financial modernization which appears to lead in the direction of EC-wide universal banking. This process of reform forces us to face up to the inadequacies of our own regulatory system if we hope to keep up in the 1990s.

By contrast, despite the beginnings of change, the Japanese regulatory structure does not appear to offer us an attractive model for reform. Rather, the well-reported success of Japanese banks is a function of interest rate controls, a national policy of treating banks as an important competitive asset, the trade surplus, and a high savings rate.

In light of the developments described above, how do we find our banks faring against their international competitors? The competitive position of U.S. commercial banks in global markets today can be measured in different ways. By many measures, we are losing market share and competitive standing, both at home and abroad. On the positive side, in some areas our banks continue to innovate and to develop new products and services, such as financial advisory services, interest rate swaps and various consumer banking products such as debit/credit cards, electronic banking, and mortgage products.

In terms of assets, U.S. commercial banks have fallen behind foreign commercial banks in the global banking market. Foreign banks have also increased their share of assets in the U.S. market. Specifically, U.S. banks' share of international banking assets has fallen from 27.2 percent in 1983 to 14.1 percent in 1989. Banks from Japan have increased their share of international banking assets from 20.5 percent to 38.3 percent over this period. Banks in France and Germany experienced moderate increases in their share of international assets in this period, although British banks have retreated somewhat. Part of the U.S. international share decline reflects exchange rate changes: with a higher value of the Yen and European currencies, the dollar value of foreign currency deposits abroad is greater.

During this same period (1983 to 1989), foreign banks have increased their share of U.S. commercial and industrial loans from 21.4 percent to 28.5 percent.

While these figures indicate one important aspect of competitiveness, one should not look exclusively at assets, because size may not be a good indicator of performance. Capital strength, profitability, skill of management, and innovativeness are all elements of international competitiveness where U.S. banks have fared better than they have in comparisons of asset size.

Nevertheless, U.S. banks have faced difficult times in the late 1980s due to economic and structural factors beyond their control. These factors help explain the reduced competitive standing of U.S. banks, and include:

- the U.S. balance of payments deficit;
- the relatively low U.S. personal savings rate;
- the relatively high U.S. cost of capital;
- the trend toward disintermediation; and
- the structural rigidities of the U.S. financial system.

Given this situation, the Committee's review of the status of the banking system and proposal for regulatory reform is timely as is its consideration of the Fair Trade in Financial Services Act of 1990. We share the objectives of this bill which is designed to open foreign financial markets and ensure effective market access for U.S. firms. As you know, however, the Administration has opposed the bill because of our concern that even limited reciprocity could invite retaliation and lead to still further measures -- a slippery slope. We are in the process of reviewing revisions as the bill moves forward.

IV. Guiding Principles for Regulatory Changes

As I mentioned at the outset, it is impossible to develop specific recommendations for change in the U.S. system without considering their broader relationship to deposit insurance and other elements of the federal safety net. The fundamental structural issues that must be addressed in financial institutions reform include the appropriate relationship between banking and other financial services, and between banking and commerce; the extent and usefulness of firewalls; and the extent to which consolidated supervision is necessary -- all of which are interrelated. These and other structural issues will be addressed in our study of deposit insurance. Nevertheless, it is possible to make some general observations and identify several guiding considerations.

The overall considerations in recommending any changes to the regulation of financial services must include: (1) the competitiveness of U.S. financial firms and markets; (2) the exposure of the taxpayer through the federal safety net; and (3) the stability of the financial system. Some have argued that the first consideration conflicts with the other two -- that enhanced competitiveness through broader powers will automatically increase the exposure of the taxpayer and destabilize the system.

But is that necessarily so? U.S. banking organizations are losing traditional businesses to new technologies and new markets, yet they are not permitted to fully adapt to new lines of business. The result has been concentration in the riskiest lines of permitted business, such as commercial real estate lending, highly leveraged transactions, and loans to lesser developed countries, that creates greater risk to the system and the taxpayer, not less. The ability to adapt prudently to changes in the marketplace could reduce that risk by fostering growth in fee income and diversification of funding sources and asset risk. Moreover, properly supervised diversification into other financial activities could contribute to greater profitability, diversified risk, and a stronger capital base.

Finally, it may also be possible to insulate the federal safety net from the increased risk created by new activities. The fact is that every developed country has some form of broad safety net for its financial firms, yet most countries permit their firms to engage directly or indirectly in a broader array of financial services than we do. At the same time, there have been few substantial losses to their systems and none anywhere near the magnitude of our thrift losses.

The challenge, then, is to devise reforms that will reduce or contain the risk to the taxpayer while at the same time increasing the long-term stability and competitiveness of our financial firms.

It seems to me that there are a number of important principles that ought to be embraced in any future recommendation for change. These are set forth below.

1. Capital. Broader activities for banking organizations ought to be linked to strong capital requirements, preferably risk-based. We learned all too painfully from the thrift crisis that a crucial protection for the taxpayer is requiring firms to have a substantial amount of their own money at risk to absorb losses. This Administration has consistently insisted on prudent capital requirements for financial firms that have the potential to expose the government to losses, whether they are thrifts or government sponsored enterprises. Moreover, the Federal Reserve Board recently testified before this committee that enhanced capital is a critical element of any proposal for reform.

Reliance on stringent capital requirements and increased market discipline can serve as an offset to excessive regulation. And to attract sufficient capital, banks must be profitable. Thus, any regulatory reform must be undertaken with a view to enhancing the profitability of our system. To put it another way, the surest way to threaten the safety and soundness of our financial system is to render it unprofitable.

2. Uniformity of Regulation. Our system of regulation has become a hodge podge, gerry-built structure of rules and exceptions. Whatever direct or indirect activities are authorized for banking organizations, they ought to be authorized on an equal basis for comparable institutions. We need rational regulations consistently applied.

3. Functional Regulation. The Treasury Department has long supported the concept that the primary regulation of financial activities should be by function, rather than by institution. In general, we believe that a firm's securities activities should be regulated by the Securities and Exchange Commission; its banking activities by the banking regulators; its insurance activities by the state insurance authorities; and so on. This is more efficient than having different agencies each regulate a range of different functions.

4. Streamlining Regulation and Supervision. Our system now has three federal bank regulators; one thrift regulator; one credit union regulator; and 50 state regulators. Regulations and regulatory responsibilities are often overlapping and duplicative. The banking supervisory structures of most of

our major competitors are, by contrast, more unified and coherent. As we explore the reform of our financial institutions, we will also need to explore the reform of our regulatory structure -- although, to be frank, the inevitable turf fights involved may prevent the full achievement of this goal.

5. Efficient Geographic Diversification. Interstate banking permits banks to diversify and avoid being too closely tied to the vicissitudes of local economies. Because of the actions of state legislatures, full interstate banking is fast becoming a reality. As of January 31, 1990, only four states did not permit some degree of interstate banking. Yet interstate branching is for the most part prohibited, even though it will entail lower costs than establishing separate banks in separate states with separate capital structures and separate officers and directors. Any reform proposal should carefully examine the concept of interstate banking and permit market participants to determine whether it is more efficient to branch or to establish separate subsidiaries.

6. International Convergence and Harmonization. With the increasing interdependence of national financial systems, we support international efforts toward convergence and harmonization where appropriate of the supervision and regulation of financial firms. The Basle agreement on risk-based capital

promises to be successful, and we can expect this type of convergence effort to extend to other kinds of activities. It is imperative, as other systems develop and progress, that we keep pace; we should not be left behind from any movement toward the standardization of the rules governing the international provision of financial products and services.

7. Market-based Structures. Much has been written about the appropriate structure of financial firms that have access to the safety net. The three basic models are:

(1) the U.S.-style holding company, in which banking activities are carried out in a banking subsidiary of the holding company, and non-banking activities are carried out in separate subsidiaries of the holding company;

(2) the English and Canadian-style universal bank, in which banking activities are carried out in the bank, non-banking activities are carried out in direct subsidiaries of the bank, and no separate holding company exists; and

(3) the German-style universal bank, in which a single entity engages in all banking and securities activities directly but through segmented departments.

The **Chairman**. Very good. Again, you've given us an excellent statement, and I think it takes into account the fact that you're in the process of completing the work on the deposit insurance reform evaluation and completing the recommendations.

Let me call on other members of the panel for their opening comments and then we'll proceed to questioning. Senator Dixon?

Senator **Dixon**. In the interest of time, Mr. Chairman, I'll just ask that my statement be reproduced in the record in full so I can have the opportunity to question the Secretary.

But I want to say that, with very few exceptions, it's good to see the Secretary again this morning. [Laughter.]

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as we continue our hearings on modernizing the regulation of financial services. We have the distinguished Secretary of the Treasury before us this morning, and I look forward to his testimony.

This committee has a lot of tough issues before us. We have the question of deposit insurance reform, on which this Senator and other members of this committee are hard at work on. We have the powers question, which we have been unable to make any pogress on, let alone to legislatively resolve, in my time in the Senate. We have numerous other issues related to the safety and soundness and competitiveness of our banking system.

As I have stated many times before, it seems to me that it is beyond dispute that the current statutory framework governing the banking industry and other components of our financial services industry is badly out of date and needs fundamental reform. Changes in our economy, technological changes, the increasing internationalization of financial markets, and numerous other factors have combined to create a situation where our existing regulatory system is simply no longer adequate—it just doesn't fit any more.

I hope the Treasury Secretary will be able to provide this committee with some help as it seeks to prepare solid, workable reform legislation that can be enacted quickly next year. Action is long overdue. We cannot afford to waste any more time.

The **Chairman**. Senator Sanford.

Senator **Sanford**. Thank you, Mr. Chairman. I think I will simply put an opening statement in. Unlike Senator Dixon, I'm always glad to see the Secretary. It's just that I don't agree with him sometimes.

The **Chairman**. We'll make Senator Sanford's statement a part of the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator **Sanford**. Mr. Chairman, today, Secretary of the Treasury Nicholas Brady joins the long list of highly regarded experts and public officials who have testified before this committee on the need for modernization of the United States financial services industry. It is of great credit to you, Mr. Chairman, that we have had such a distinguished group of informative witnesses to guide us as we work toward substantive reform of the American financial sector. I thank you for your diligence in putting together this series of extremely helpful hearings designed to clarify and define the complex problems in the banking community and the numerous proposals put forth to correct those problems.

Secretary Brady, let me also thank you for coming today to share with us your insight into the lagging financial services industry. This is an issue of the greatest levity, upon which the Senate must soon take action. If the United States is to remain an international leader, we must accept the fact that a strong economy, driven by healthy, competitive financial institutions, is essential to the emerging new concept of world power. To cling to an outdated financial system in this age of an increasingly powerful Japan, a reunited Germany, and a consolidated European Community is to deny America continued global strength in the decades ahead.

Mr. Secretary, as we discuss broad modernization, I will be particularly interested to hear your opinions on the importance of deposit insurance reform as it relates to the successful restructuring of the entire financial services industry. It seems to me that Federal deposit insurance currently represents the most significant liability to the Government and the American taxpayer. It therefore behooves us to give this important part of the financial system close scrutiny as we consider any fundamental change.

Once again, I thank you for your time, Secretary Brady. I look forward to your testimony and the question-and-answer period which will follow.

Thank you Mr. Chairman.

The **Chairman**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. I'm also pleased the Secretary is with us. I do not have an opening statement. I'm looking forward to his responses to questions.

The **Chairman**. There are a couple of things I want to get into early here. Over the last year and a half we have been trying to deal with the thrift situation and write the reform legislation to get it in place, get it enacted and so forth. As it relates to deposit insurance, we've just received some data within the last couple of weeks that I want to share with you and ask you a specific question about.

In terms of the pattern of failures that we've seen in the thrift industry, it turns out that the overwhelming majority of the cost of the failures, the number of failures and where they occurred, has been in State-chartered institutions in a handful of States. To give you an idea—and I don't know that you want to write this down, but I'll just give it to you in series form so you can have it in your mind—the total cost of the thrift problem by year 1987, State-chartered thrifts that failed, constituted 66 percent of the total.

In 1988 that jumped up to 75 percent of all the thrift losses were in State-chartered institutions. In 1989 it went up to 92 percent. So far, in 1990, according to OTS, and they tell us this number is low and it will go up, it's 59 percent. So the running average from 1987 through April 1990 is about 73 percent of all the thrift losses have occurred in State-chartered institutions.

It's interesting that if you go behind that data, you find that two States predominate: Texas and California account for 54 percent of all of the S&L losses. This is just State-chartered institutions now. In 1987, the figure was 54 percent. In 1988, 74 percent of all the national losses were in the State-chartered institutions in those two States. The figure for 1989 is 62 percent. So far in 1990, 57 percent. The average, again, over the period of years: 67 percent.

So you've got fully two-thirds of all the national savings and loans losses occurring in State-chartered institutions in just 2 States, Texas and California. We asked the RTC to give us a summary of assets that have been taken back in repossession that we now all own as taxpayers of these failed thrifts. We found—and to me, this is an astonishing statistic—that as of June 12, 1990, in the scrap heap of repossessed assets, everything from vacant houses to golf courses to marinas to whatever they happen to be, 69 percent of the total book value of all of those assets are found within the boundary lines of a single State, namely the State of Texas.

Sixty-nine percent of the total asset value is there. And when you cross-relate that to these loss figures from State-chartered institutions, you start to get a pretty clear sense as to what blew the hole in the side of the ship.

My question is this: As we go through this financial modernization, I no longer see any reason why any longer we should allow Federal deposit insurance to be stretched out and allowed to cover activities that individual States want to provide in the way of operating authorities to institutions within their States, whether they happen to be S&L's or banks, whatever it happens to be.

We changed that dramatically in the Savings & Loan reform legislation, as you know, and we really put a stop to what I consider to be the abuse of State powers in that area. But as a guiding principle, I would like to ask you if you would agree with the proposition that looking forward to try to avoid any other kind of financial disaster of this kind, that if we are going to have Federal deposit insurance in place, that we define at the Federal level what that covers and protects, and that the States not be allowed to go beyond that in terms of providing other kinds of activities. And, if they do, that they accept the responsibility of providing whatever the insurance system or some other protection scheme might be to back up those other kinds of activities.

It just seems to me that if we do deposit insurance reform and we allow Federal guarantees to underwrite decisions that are going to be made by other units of Government that are very difficult to supervise and that are beyond our view, we run the risk of exactly the kind of problem with these data that we now see in the savings and loan situation.

What would be your thought on that?

Secretary **Brady**. Senator Riegle, I think the general thrust of what you said is sound, particularly in light of the evidence that we now have that State regulation was not what it should be. The idea that it should carry with it some right to federally guaranteed deposits is something that the public would not understand.

The **Chairman**. We are finding a lot of resentment that is building up around the country because areas of the country that do not think they caused the problem are resentful of the notion that they are being asked to ship a lot of money to the areas of the country where the problem did happen. So I appreciate having that statement on the record.

With respect to the idea of trying to have a legislative package ready to go as we start out the next calendar year in the next legislative session, is that the goal of the administration, as you would see it today, to try to have a package ready to go so we could be off and running right crack out of the box starting in 1991?

Secretary BRADY. As I think my testimony indicated, Chairman Riegle, the competitive posture of the U.S. banking system in comparison with firms around the world has measurably decreased. Therefore, we should do something about it.

The banking system is a national asset, and we should be clear about our instructions to the people in that industry as to how they should compete to improve our position against the rest of the world. So in answer to your question, I think our study will be finished by the end of this year and we will be ready for testimony before your committee at that particular time. But I think 1991 would be an excellent time to address these problems completely and to try to put forward some proposals that would bring us back to where we were 10 years ago.

The CHAIRMAN. Just one other thought on that, and then I will yield to Senator Garn. I would hope that the administration would not present a comprehensive legislative package. I would hope we could work back and forth in a discussion leading up to that, but in any case I think it is very important with the package we put on the table.

I would like to suggest that that include at least four major items:

One of course being the deposit insurance reform issue, which you directly addressed today;

The bank powers issues;

The structural reform issue—you mentioned both of those; and I think the interstate banking issue, as well.

If we have got a package that takes into account all four of those items in a comprehensive way, then I think we have got something that really would have the kind of wall-to-wall scope and sweep that is appropriate. I am wondering if that sounds sensible to you, or if you would react to that.

Secretary BRADY. I think those are the main issues.

The CHAIRMAN. Very good.

Senator Garn?

Senator GARN. Thank you, Mr. Chairman.

During this series of hearings we have held on modernizing our financial system, virtually all witnesses have agreed that Glass-Steagall should either be repealed or revised. However, there has been some disagreement over the effectiveness of firewalls.

Gerry Corrigan, President of the New York Federal Reserve Bank, warned that firewalls would either eliminate synergies or be ineffective.

Fed Chairman Greenspan also cautioned that the downfall of Drexel-Burnam evidenced the ineffectiveness of firewalls.

SEC Chairman Richard Breeden last week nonetheless advocated the use of firewalls, not so much to prevent failures but to isolate them within individual subsidiaries.

What are your views on these different views on firewalls? What are your views on the necessity or lack of necessity as we restructure and modernize of having firewalls?

Secretary **Brady**. Well, Senator Garn, I do not mean to be cute, but all of the above to some extent. I think that firewalls cannot be counted on to be the "be-all" and "end-all" and just let banks set sail on their own. There has to be guidance from the top from the Federal regulatory institutions, and I think that firewalls are useful, but we should not think, having put them in place, that all problems are solved.

So I think it is particular to the individual case that you are talking about. Again, this is one of the areas that we have not studied to completion, and we are really awaiting the completion of the study before coming out for it affirmatively.

Senator **Garn**. I would agree, Mr. Secretary, that although firewalls cannot guarantee total security, I think it would be a mistake to conclude from some of this testimony that they should not be there, because I think we should make a very clear distinction between some products and services that, while we would allow financial institutions to get involved with them, that they should not have Federal deposit insurance. There would be activities that, very simply, should clearly not be covered up to $100,000 of deposit insurance, and people understand that those funds are at risk.

While that is not a guarantee that we would not have failures, it at least makes a very clear distinction between insured funds and non-insured funds.

Chairman Breeden also raised the idea in his testimony of charging savers market-determined premiums for deposit insurance. He also suggested that banks be allowed to offer both insured and uninsured accounts as a possible means to reduce the aggregate level of insured deposits.

Do you have any feelings on Mr. Breeden's comments?

Secretary **Brady**. Only to say that that is the subject of a study that we are making, Senator Garn. We do not have a conclusion at this particular point.

Senator **Garn**. There is another issue that has been rearing its head every year that I have been here. That is, a lot of the independent community banks argue that foreign deposits in large U.S. banks are de facto covered by our deposit insurance system if the banks are considered too large to fail. These deposits are not, however, explicitly insured and the banks are not assessed premiums for their foreign deposits.

On the other hand, many foreign countries provide de facto or 100 percent protection for their international banks. If there was a perception that the United States would not stand behind international banking, what would that do to our competitiveness?

First of all, do you agree that there is de facto insurance?

Secretary **Brady**. You are talking about the safety net, now?

Senator **Garn**. I am talking about this whole argument of community banks saying there are some banks that are just too large to fail, and therefore we should charge them premiums on their international deposits. It is that whole argument of whether these reports are insured or not, and, if they are should we charge them premiums? And then the argument is whether we became noncompetitive in the international markets if we are charging premiums on those international deposits.

Secretary Brady. The argument by community banks is well made. However, the other side of the argument, which you have also stated, is out there are some banks which, if we allow them to fail, would present such a risk to the system that you do not want to find out what that risk is. I think that is one of the anomalies of the system that we have to continue to study. But I must say that the safety net is a system that is used not only in this country but in a lot of other countries around the world.

Senator Garn. Let me just turn for a moment to the issue of how we have computed the S&L losses over the last couple of years. We have held endless hearings and talked about the size of the problem. The last time you testified, you testified that it was a $100 to $130 billion problem. Yet recently I have heard estimates, not just of $500 billion but as high as a trillion dollars.

The way they come up with these figures is obviously adding all of the interest over a period of 30 years. A couple of years ago, Chairman Greenspan when I asked him the question of what he thought the total size of the problem was, including interest, he said, well, if you can tell me what the prime rate will be every month for the next 30 years, I will be happy to give you an answer.

So obviously we are using what appears to me to be a different methodology in how we compute this by adding all of the interest in. I would use as an example, a housing bill we just passed a couple of weeks ago on the Floor that was widely supported by this committee and overwhelmingly on the Senate Floor. We talked about a cost of that housing authorization bill over a period of 3 years of $57 billion. Everybody accepted that as a reasonable estimate.

However, if we computed the cost of that housing program in the same way that some people are computing the cost of the S&L bailout, that would be a $120 billion to $150 billion program.

So, as I have said many times, what we ought to be doing is concentrating on a solution to the problem, as horrendous as it is. Even the lowest estimates are unbelievable to this Senator. But are we not using a different method of calculation for this particular problem than we do for other bills—because we could go to the Floor on every authorization bill we came up with, if we computed it in that way, and I do not know that we would ever pass anything on the Floor.

Secretary Brady. Well, you are exactly right. Those people who, for their own purposes, want to increase and exaggerate the size of the S&L problem, do so by using methods we do not use under other forms of Government accounting. They add interest. They add it over 40 years. If we did that to the Kennedy space shot which cost $30 billion in the 1960's, the cost would have been $90 billion. So it depends on how you want to look at it.

The person that buys a $100,000 house does not tell you when he is talking about that house of the interest charges connected with it. If you buy a $100,000 house and include the interest charges over the period of a traditional mortgage, it becomes a $330,000 house. You ought to say that it is a $330,000 house. We do not do it in our private life and, for the most part, we do not do it in our public life.

We do not add, in a program such as for an aircraft carrier, the cost of carrying charges. So I would say two things:

One, I think the estimates we gave this committee and have published of $90 to $130 billion, are accurate at this time. We also mentioned that if the real estate market becomes worse, since this is the basis for making these estimates, the estimates will become worse. If it becomes better, as it will some day, they will become less. That being the case, I stand by our estimates.

I also say this: I see no sensible purpose of so exaggerating the S&L loss figures as to scare and make greater the size of this problem. It is already big enough. We do not need any horseback estimates trying to triple and quadruple the size in order to make arguments. It is plenty big enough for us to face, and we will face it.

I just completely agree with your statement that the estimates that produce larger figures do so on a basis that we do not use for any other purposes of comparison.

Senator GARN. I agree. The lowest estimate of all is a horrendous figure. So we do not need to exaggerate it beyond a very bad situation as it is.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Heinz, do you have any opening comments to make before we go to the next questioner?

Senator HEINZ. Mr. Chairman, I do, but I will put it in the record, in the interests of conserving time. I understand Secretary Brady was delayed because of the budget summit.

The CHAIRMAN. Thank you, very much. We will make it a part of the record.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I join you in welcoming Secretary Brady to our committee for our 12th hearing on financial modernization and deposit insurance reform.

The Treasury Department is currently conducting a study of deposit insurance reform in the wake of the colossal bankruptcy of the FSLIC. Deposit insurance reform must be part of any legislative effort to modernize our financial system. We cannot responsibly expand the activities of insured depository institutions if it results in expanding the liability of the American taxpayers who ultimately stand behind the deposit insurance fund.

Yesterday, we held a hearing on the administration's proposal to unify regulation of the stock, stock option and stock index futures markets. More than 2½ years after the stock market crash of October 1987, Congress has still not acted on some of the major recommendations contained in the Brady report. I hope that Congress does a better job of acting when the Brady report of deposit insurance reform is issued.

Mr. Chairman, based on our experience with restructuring the jurisdiction of the SEC and CFTC, I prefer not to think about the turf battles that will erupt should we decide to change the respective jurisidictions of the multitude of banking and securities regulatory agencies as part of financial modernization. Despite the lessons of savings and loan crisis, Congress still appears too willing to let the regulated pick their regulator.

The **Chairman**. Senator Dixon.

Senator **Dixon**. Thank you, Mr. Chairman.

Mr. Secretary, a number of years ago some of us worked very hard on this committee to mark up what became known as the Proxmire Financial Modernization Act which passed the Senate overwhelmingly. I think in the context of those times that was a very good bill. It was not taken up in the House, but I think it is clear from your statement that the administration still favors broadening the powers of financial institutions in this country both as to debt and as to equity. Is that correct?

Secretary **Brady**. That is correct.

Senator **Dixon**. In a follow-up on that, let me say that there has been some criticism about the thrift experience, saying that some of that crisis could have been averted had we not broadened the powers of thrifts in the early 1980's. I think that most reasoned thought about that has indicated that broadening powers is not particularly risky if you have sufficient deposit insurance protection and adequate regulation.

In the context of talking about what we are going to do next year, hopefully by broadening the powers of banks, I ask you whether that would be your opinion that it is not risky to broaden powers, if we have adequate insurance protection and adequate regulation?

Secretary **Brady**. I agree with your conclusion. I do not think we ought to take the thrift industry debacle and make that such a big factor in our mind that we do not face the issues in the banking industry which are the ones that you have outlined.

I would also say that deregulation in the thrift industry ignored capital, and we have higher capital standards in the banking industry and I cannot imagine this committee recommending, nor would the administration, any changes in the banking laws that do not put very, very high premiums on adequate capital.

So obviously, as we look forward, we have to cast a view backward to the past. But I would not let that stop some of the changes that have already been made, de facto, in the banking industry.

Senator **Dixon**. For some months now I have been working on a risk-based deposit insurance bill that ultimately I think will be finalized in the next several weeks. I will ask you, as I have asked Mr. Greenspan and others, whether you support the concept of risk-based deposit insurance, Mr. Secretary?

Secretary **Brady**. Senator Dixon, I think it is something we should look at very closely. Our own studies of the matter are still underway, and I would beg your indulgence until we get through those studies for a final conclusion.

Senator **Dixon**. But on the basis of your expertise, you do not necessarily oppose that concept if we can develop a system with some private insurance involvement, or an incremental involvement upon which you would extrapolate the old basis-points theory for the support of the system?

Secretary **Brady**. I would look forward to looking at that kind of proposal.

Senator DIXON. Thank you.

I already asked Mr. Greenspan this, and Mr. Seidman this, and I admire and respect their opinions on this subject, and yours as well, and I will now ask you. They both indicated that they do not think you get any particular benefit out of cutting the amount of the deposit insurance at this time—that is to say, reducing the $100,000 to $75,000, or to $50,000, or to some lower amount.

I will ask you whether you have a view on that.

Secretary BRADY. My view is two-fold. One is, to repeat the fact, that we have a study that is due later this year on deposit insurance and our final conclusion will be in that. Obviously at a time when a lot of people feel that the thrift crisis was to some large extent caused by the amount of insurance, we have got to take a very hard look at that problem.

Frankly, I cannot see at this particular point in time a rush to lower the amount of insurance at a time when we have a question of confidence not only in our banks but obviously in our thrifts. So if there does come forward a satisfactory way of reducing that insurance—I do not have one in mind at this particular point in time—but we should also keep in mind that we have before us at this particular time an S&L cleanup that is plenty big enough the way it is.

Senator DIXON. Actually, the $100,000 was increased from $40,000 to $100,000 before your time and mine, Mr. Secretary, so I think we can be very objective about this. I would just say that I would be interested in knowing what the view of the administration was at some point in time, but my general impression from those that I have talked to, including Mr. Seidman and Mr. Greenspan—and I get the sense that you are moving in that direction—is that it is not sufficiently significant to be a big factor in this whole question of what we look at for the future. Is that essentially your view?

Secretary BRADY. Rather than adopting that view, Senator Dixon, I would rather wait until we get through our study. You have cited all the essential factors, and I would rather wait.

Senator DIXON. What do you think about one account? That is to say, limiting it? If we do not change the number, limiting it to one $100,000 account per person?

Secretary BRADY. If you were going to start any place, that would be the place to start.

Senator DIXON. Very quickly, because I see the red light is on, are you satisfied with capital requirements? I agree with your statement about capital requirements. Are you now satisfied about capital requirements both as to financial institutions, banks, and as to thrifts under existing law?

Secretary BRADY. Let me start with banks which are in the process of changing to higher risk-based capital requirements at this particular point in time. I do not think you can answer that question completely, although we are generally satisfied with the banking industry, until you see what additional powers might be granted banks.

Obviously, the riskier the action would lead to more capital requirements.

Senator DIXON. Of course. And I suppose you will deal with that whenever you give us that report?

Secretary BRADY. That is right.

Senator DIXON. As to the regulatory efforts, you know I think clearly that there is a substantial amount of evidence particularly in the States of Texas, California, and other places, that regulatory efforts were not at all what could be expected, I think, to keep sound business practices in place in institutions.

Are we now, in your view, adequately regulating at the Federal level both as to banks and as to thrifts with respect to the powers they at least now have? And will we continue to be conscious of that with respect to any broadened powers we might give banks?

Secretary BRADY. Yes, we will.

Senator DIXON. And you feel satisfied that regulation at both levels is adequate now?

Secretary BRADY. I think, particularly with regard to FIRREA, an enormous improvement has been made. I think there will doubtless be, through the terms and conditions of the FIRREA legislation, an assurance that we will have a thrift industry that will continue in existence in this country and that it will not be subject to a repeat of what we have seen in the S&L debacle.

Senator DIXON. If I may say to you, Mr. Secretary, the red light is on, but speaking as only one member of this committee, others here have discussed it from time-to-time, that I want to say to you and the administration that if there is any doubt about adequate regulatory effort as to thrifts and as to banks, and additional people and additional funds and things of those kind, I hope that you would tell us here in this committee so we can actively support you.

Secretary BRADY. Thank you.

The CHAIRMAN. Let me just indicate for the record that Senator Pressler very much wanted to be here today. He is not. His father has passed away, sadly, in South Dakota. He is there for that funeral service. So certainly the committee, and all of us, extend our sympathies to him and his family.

I ask unanimous consent that the statement and questions that he otherwise would have presented in person be made a part of the record, and I ask for your formal response to those, Mr. Secretary, for the record.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Secretary, let me join again in commending you for the magnificent presentation that you put forth in terms of your studies and what you will be looking at. I think obviously 1991 is going to be a very busy year for this committee in undertaking many of those recommendations.

I would like, if I might, to go back to an area that you have testified to before this committee. It relates to an article that appears in yesterday's New York Times in which it talked about an association, the Mairini Association, which follows program training, that says that it had tracked four selling programs and seven buying programs. This is in relationship to the kind of wild gyrations we saw in the market Monday with a 102-point drop at one point in time.

It said that in tracking these four selling programs and seven buying programs with net impact clipping the Dow by some 18 points, it added that a 35-minute series of selling programs beginning at 10:12 a.m., knocked 74 points off the Dow, thus accounting for most of the 108-point drop.

We have talked about the need for reform, and I come back again to a point that several have made—not many in the industry—that the program trading has not benefitted the individual investor. Indeed, it has been used by the brokerage houses for some of their larger accounts and is not driven by the market itself.

What, in addition to regulation on the Chicago side, do you see us doing in the interim? Should we just wait? I share your feeling that one of these days we are going to pick up the paper, or we will hear on the nightly news of a drop of 250 or 200 points or more. I think that roller coaster is just a question of time before it breaks through that safety net.

Secretary BRADY. I think you stated it well, Senator D'Amato. It is a question of time, in my opinion. That is why I and the Treasury and the administration have been strong backers of the bill that Senator Heinz, Senator Wirth, and Senator Gorton introduced which attempts to deal with this particular problem.

A 100-point drop in an hour this week provides graphic illustration of that about which we should worry. Frankly, I happened to be in my office when that took place. We have new instrumentation in the Treasury at this particular point in time which was put in during this last year so that we can follow various different markets and their fluctuations.

I went down and watched the market gyrate with, frankly, no sure knowledge as to which way it was going to go. It happened to tilt back up again and we were grateful for that because nobody wants to see one of these big swings which frightens the small investor and has the potential to destabilize the system.

I can only repeat what I said before, which is that I think we ought to put into law the changes that are embodied in the Heinz legislation, and we ought to do it right away.

Senator D'AMATO. One of the suggestions, Mr. Secretary, that I have received would be to make the program trading more costly. Program traders could be assessed the real costs for increasing the automated auto-execution facility at the exchange. That is rather technical. Maybe we could get somebody to take a look at that and discourage this. But it has no relationship to the underlying value of the stocks, this wild gyration, and it is riverboat gambling and the public is really placed at risk.

Secretary BRADY. Senator, let me say this. I do not think there is anything wrong with big volume that is connected to investment.

Senator D'AMATO. Underlying value.

Secretary BRADY. That is right. What we do not want is big volume connected to speculation, because we know that will produce these wild swings in the market.

Senator D'AMATO. Is that not the index arbitraging?

Secretary BRADY. It is the Index arbitraging. I just want to be sure that we are on the same wave length with regard to program trading. Program trading itself is a system of executing large amounts of transactions because of the advantages that computers have brought us.

If that method of program trading was used for solid investment, I do not believe you would see the wild swings that we now see. It would be more orderly and over a period of time. It is the program trading that is attached to speculation that we have to worry about, and I know that is what you were referring to, as well.

Senator D'AMATO. I am glad you made that point, Mr. Secretary, to clarify, because that is what we are talking about. We are on the same wave length.

One other point, if I might, Mr. Secretary. I know that in the summit as it relates to the budget there has been talk about, obviously, the areas of raising revenue. Without breaking any of the confidences that have been placed in regard to that, I am not going to ask you to break that confidence. But I share a concern as it relates to the possibility of placing a transfer tax on stock transactions.

I note that the Congressional research service estimated that the enactment of this could affect the Dow Jones Industrial Average by as many as 200 points. I think at this time, given, I would say, the skittishness—at least it is a rather skittish market—this could only exacerbate that problem.

I also note that we have had testimony again from the United Kingdom and Germany that they are moving to eliminate their taxes on securities transactions. Japan and Italy had reduced theirs. Canada does not have one. It would seem to me this would be an inappropriate time to move in that direction, particularly when I note that over 400 United States companies already trade on foreign exchanges.

So I mention this to you, Mr. Secretary, because I think it could have a devastating impact on the market. I want to work with you on this area of concern that you brought to us now a number of times, and with my colleague Senator Heinz. I think we are headed for a disaster unless we do something to deal with those problems as it relates to the kind of program trading that does not bring about any benefit to the system, but makes profits for people not based on underlying value. That is simply wrong and places everybody else at risk.

Thank you, Mr. Secretary.

The CHAIRMAN. If I may, I will just be very brief on this. I want to just do a follow-up on what you were talking about with respect to working back and forth between the futures market and the underlying stock market.

Yesterday, Leo Melamed of the Chicago Merc was seated exactly where you are seated now. We had a discussion on exactly this issue of the interrelationship and the resulting background of who should be the regulator of these contracts. I asked this question of him. That is:

If you get a market break such as we saw on Monday and you get a big drop in a hurry, and you have got traders who want to sell in the face of declining markets on the theory that it is going to go lower and they will cover themselves at a later point, is there an inherent efficiency in the futures market for somebody who is trying to get to the exit first in a breaking market versus the underlying securities market?

In other words, we were trying to figure out the back-and-forth relationship, and we talked then about the fact that in the futures market the circuit breakers kicked in the futures market, and they had a 30-minute suspension, and that appears to have helped. But it struck me that it may well be that when you get a genuine market break occurring, and you have got a lot of people who want to sell in a hurry and want to sell a spread of stocks, that it may well be applied for margins and everything else that the ability to sell rapidly may in fact be easier for that kind of a seller in the futures market, and you may get an exploration of activity there.

And then of course whatever the playback effects are in the underlying securities market. But you have lived in this area for a long time. Might that be right? Might there be an advantage in terms of speed in that transaction by going to the futures market for somebody who is really trying to get out the door ahead of the falling market?

Secretary **Brady**. With regard to speed, I would think the answer is probably, yes. The advent of the computer where you have the futures index in Chicago of the 420 S&P, 425 stocks, and you have the ability in New York to replicate that index by use of computers, I think the real worry is that adding together they can produce an absolute tidal wave of selling or buying in some cases.

But when people get scared, the effect on the market seems much greater. So I would think what it does is really add to the volume when the bad news, whatever it is, becomes evident. I would also say one other thing, Senator Riegle.

The concept of one market, which was originated in the 1987 Stock Market Study that I chaired, came forward with the idea of circuit breakers. This was a new idea. It was widely contested at that particular time. Everybody thought it was a tremendous invasion of private enterprise, and the end of the world was going to come if we instituted that.

Now one of the positive results of the 1987 investigation is that that circuit breaker is in effect. It does help. It did help, in my mind, yesterday because it allows the human mind to catch up with what is going on in the markets. Partly in answer to your question, I would say that whatever it was that was going on in Chicago was stopped for ½ an hour, the market was allowed to settle. That is an enormously important contribution to the stability of the market.

The **Chairman**. I do not mean to trespass on Senator Graham's time. Thank you, Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

Mr. Secretary, on July 18, Mr. Greenspan was here. I asked him a couple of lines of questions which I would like to essentially repeat. They both go to the question of the sense of urgency with reference to economic circumstances of the Nation and what Congress and the administration should be doing at this time.

The first series of questions was predicated on an interview that had been held two days earlier by the Federal Deposit Insurance Corporation, Mr. William Seidman, which was reported in The Washington Post and other papers on July 16. Mr. Seidman stated that the insurance fund that protects the deposits of U.S. banks is "under considerable stress" and "would be in trouble" were the Nation to suffer a serious recession.

The article goes on to quote Mr. Seidman as saying "We can handle anything we can foresee right now," Mr. Seidman said, "but if things come along, major failures that we are not able to foresee at this time, that would be another story. The system is under stress."

There is no question about it, and our insurance fund is under stress. Do you share that appraisal of the Federal deposit insurance fund?

Secretary **Brady**. Well, Senator Graham, the statement that Bill Seidman made is one that he is much better qualified than I to make. He studies these matters every day. But I do notice the qualifications in his statement "under severe recession" that the FDIC fund would be threatened. I do not know what assumptions went into the calculation of "severe recession." You certainly could have a severe recession that would threaten a lot of things, and we cannot base our estimates of how we are going to conduct business on a severe recession, although that ought to be taken into account.

If you did, how about a severe-severe recession, which would produce probably the requirement for the banks to pay deposit insurance charges that would place this country at an even greater comparative disadvantage with international competitors like Japan and Germany.

So I looked at that time. I wake up and read the papers at 6 o'clock in the morning. I read the headlines. I must admit, I gulped. But by the time I got through reading it and saw the qualifications on the statement, it did not alarm me. "Severe recession" is going to mean trouble in a lot of areas. The point is to stay out of a severe recession, which I think we will do.

Senator **Graham**. Are there any actions you would recommend that Congress should initiate relative to the Federal deposit insurance fund?

Secretary **Brady**. Not at this time, although we are studying the matter. I have asked Bill Seidman to give us any conclusions he might have so we can look at them.

Senator **Graham**. I will conclude this series of questions with the same comment I made to Mr. Greenspan. The answers that you and Mr. Greenspan have given us are eerily reminiscent of the answers that were given in 1988 by Mr. Gould at Treasury and Mr. Wall of the Federal Home Loan Bank Board when asked almost precisely the same questions relative to the FSLIC insurance fund, the Savings & Loan insurance fund. They were asked, was there a problem and was any congressional action called for. The answer was, there was no problem; we have the resources to deal with any issue that may come before us and any Congressional action would have the negative effect of raising public apprehension unnecessarily.

I asked Mr. Greenspan, in the context of that recent experience, if he would monitor the situation of the FDIC and if he ever comes to a conclusion different from the one he gave on July 18, if he would quickly report that to us. I would make the same request of you, Mr. Secretary.

Secretary **Brady**. I will certainly do that, Senator Graham, but I do not think that is a fair comparison because, why do you not ask me what I would have said in 1988? Looking at that legislation, I can tell you I would not have made the same statement.

To compare the banking system in the United States now with the savings and loan situation in 1988 is a comparison that I do not think we should make. There are problems in the banking system, but we are working on them. Some of the things we are thinking about today will come forward in our study, and hopefully that will make it better. But if your comparison is just to indicate that I would have made that statement in 1988, I do not think that is either a fair question or a fair comparison.

Senator **Graham**. I am not saying what you would have said in 1988. I am saying what in fact was said in 1988 by the Chairman of the Home Loan Bank Board and the person representing the Treasury as it relates to the Savings and Loan industry. Those are matters of public record. I am concerned that we not have a repetition of that in 1990.

The second line of questions, which again goes to the issue of urgency, is: On January 31 of this year, approximately 6 months ago, President Bush delivered his State of the Union Address. That Address contained the following quotation under the category of controlling the deficit:

> We have made real progress. Seven years ago the federal deficit was 6 percent of our gross national product, 6 percent. In the new budget I sent up 2 days ago, the deficit is down to 1 percent of the gross national product. That budget brings Federal spending under control. It meets the Gramm-Rudman target. It brings the deficit down further and balances the budget by 1993 with no new taxes.

As I calculate the circumstances 6 months later, we had an announcement of a $164 billion deficit, which is approximately 3 percent of the gross national product. We have a Social Security Fund in which the surplus did not exist on the scale that it does today 7 years ago, which represents approximately 1 percent of the gross national product, and we have an S&L bailout which did not [illegible] 7 years ago, which also equals approximately 1 percent of the gross national product.

So that as of the end of July 1990, the Federal deficit is 5 percent of GNP, as compared to 6 percent of what the President stated that it was 7 years ago, and the 1 percent he thought it was going to be as of January.

My concern is this: If circumstances could change so dramatically in just this 6 month period, what does that say about the state of the American economy? And what are the reasons that you think account for this dramatic shift between January 31, 1990 and July 25, 1990?

Secretary **Brady**. Let me say, first of all, I do not think you should add the savings and loan cleanup expenses to the size of the deficit. Those are not structural, and they will not continue over the years. Even CBO estimates that by early 1993 or 1994 they will be returning funds, because the assets will be sold out and they will be self-correcting. So I do not think it should be added.

However, there are two points that I would make:

There are a number of things that have changed since the President put forth his budget. First of all, we have had a slowdown in the economy which has contributed substantially to the increase in the deficit.

Second, there has been more spending than we thought there should be. There is a question of whether the spending should continue at the rate that it is now going on. The obvious conclusion is that it cannot continue. However, I would say to you that I am not going to do what we have agreed not to do in the budget summit negotiations, which is to get into one-sided inflammatory statements, because all the budget participants have agreed not to do that.

All I would say is I commend the President for his leadership in calling the summit together. I commend him for his forthrightness in saying that there are no preconditions, and stating specifically what the conditions for proper resolution of the budget agreement are.

I think that if the good will that he has exhibited in this process continues, then the other participants will get a resolution to this problem.

Senator **GRAHAM**. The concluding question is: Is it your statement that the circumstances that caused this significant shift in economic forecasts between January and July do not require any action by the Congress? There are no initiatives the administration would recommend that Congress should take in light of these facts?

Secretary **BRADY**. Are you talking now about the budget summit, or the testimony this morning?

Senator **GRAHAM**. I am talking about comprehensive—is there anything that Congress ought to do that the administration would suggest relative to changing the circumstances that have led to this dramatic shift in our Nation's economic position from January when we were talking about a 1 percent of GNP deficit, to today where we are talking about 4 percent, if you exclude the S&L's, and 5 percent if they are included?

Secretary **BRADY**. Again, I fervently hope that there will be a budget summit agreement. If there is a budget summit agreement, it will contain changes of all manners and sorts, and I hope that when the budget summiteers come forth with that agreement that we can count on the support of all members of Congress.

Senator **GRAHAM**. Thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Heinz.

Senator **HEINZ**. Mr. Chairman, thank you.

Mr. Secretary, welcome back once again. Let me go to the root of a question that I am sure concerns many people, as well as many members, and it is this:

There is a very strongly held view by many people that the S&L crisis was caused by the expansion of the permissible activities of thrifts, so-called "deregulation." Indeed, the principal argument against expansion of banking activities is, as you know, that it increases the risks to the deposit insurance system and ultimately to the taxpayer.

Others argue, to a certain extent as you did on page 23, that the restrictions placed on the activities of thrifts resulting in a large concentration of mortgage loans without the ability to diversify assets were the root cause of the S&L problem.

My question is: Which view is correct, and why?

Secretary **Brady**. Well I would say, to try to answer your question directly, that the principal reason for the S&L problem was lack of capital in the system where we had federally guaranteed deposits. I cannot think of anything in the history of this country which exhibits less common sense. So I think the fix that you made this last year in FIRREA firmly addresses that problem I think by putting up capital.

If you have sufficient capital, and the guy who is making the decision whether to buy or not buy a golf course or a condominium and he knows his money is coming first, then you can obviously have broader powers. But the idea that you can have broad powers and no capital by the owner and the executives of the business does not make any sense at all.

Senator **Heinz**. Since there have always been capital requirements on all depository institutions, I would conclude—rightly or wrongly—that there was a regulatory failure then; that the regulators did not require that there was adequate capital.

Secretary **Brady**. That is correct, except that the adequate capital that was required, as I am sure you are well aware, was too low, as well.

Senator **Heinz**. It certainly was. I wonder if anyone has ever looked at whether, even if S&Ls had been much more substantially capitalized, that the kinds of activities that have added up to this $90, $120, $150 billion—nobody knows what the number is—in terms of what we would pay if we paid right now, if those losses just would not have been so large as to wipe out the capital in the 500 institutions to which those losses are attributed, even if the capital is twice or three times as much?

Secretary **Brady**. I do not think it is a question of whether the capital was exactly the right amount, Senator Heinz, it is a question of whether if people had their own money on the line, they would have made the same foolish, irresponsible decisions. My answer is that they would not have.

If you could put up 1 penny and get a million dollars of Government-guaranteed money which allows you, if you gamble and win, to be the total recipient of the benefits of that win, and if you lose you would just be a minor participant in a loss, you would take any kind of a chance. I do not think—although I see what you are driving at—you can simply measure the amount of additional capital that would, say, be included under a FIRREA law and try to say, would that have been enough?

I think what you really have to determine is, if these guys had their own money on the line, would they have taken the same chance? My answer is that they would not have, not even close.

Senator **Heinz**. When Chairman Greenspan was before the committee he argued, as you do, for higher capital, but he implied that higher capital by itself would not be enough because he also asked for more frequent and stringent examinations, supervisory actions such as dividend restrictions for banks failing to meet capital requirements and, quite importantly, early closure of failing depository institutions prior to insolvency. That is to say, if you have got a problem, do not wait until it costs the taxpayer money.

Do you agree with Chairman Greenspan's outline of what needs to be done?

Secretary **Brady**. Chairman Greenspan has made the same statement in discussions with us at the Treasury, and we are looking at those concerns, Senator Heinz. Certainly something like early closure, if you could nip an incipient disaster in the bud, that makes good sense and we are trying to figure out how you might do that.

Senator **Heinz**. Would you disagree with the other three?

Secretary **Brady**. No. I would not disagree with them. They are worthy of real study, and we are doing that.

Senator **Heinz**. I just wonder why, if these are good ideas and higher capital has been talked about a lot, why the Fed and other regulators did not implement these policies in the past.

Secretary **Brady**. I do not know. I think maybe you ought to ask them.

Senator **Heinz**. One of the questions that we get into——

Secretary **Brady**. I answer enough questions about the Fed these days without broadening that line of inquiry.

Senator **Heinz**. Very well.

One of the questions that is raised about the diversification of banks' opportunities to earn is, for example, that they have a competitive advantage represented by deposit insurance, access to the Fed window, and so on, that allows them to have an advantage and that that should be eliminated when banks compete on what you might call "free market turf," whether it is securities, or insurance, and so forth.

Do you agree with that view?

Secretary **Brady**. I think the so-called "level playing field" concerns that competitors with commercial banks who are in other lines of endeavor—insurance, the investment banking industry, and the like—have with the banks who want to be let into their businesses, that perhaps the same advantages which the commercial banks have in having the Federal safety net, access to the Fed window, the ability to attract capital because of that degree of support from the government, are real concerns.

Senator **Heinz**. So there ought to be a level playing field?

Secretary **Brady**. I think we have to take into consideration the concept of a level playing field when we make these changes. How level you can make it is something we are all having various degrees of difficulty or success with. So we have got to keep at it.

Senator **Heinz**. Maybe you have anticipated my next question. If you can—and we all understand there are plenty of difficulties in making this field level—but if you can do it, what about those activities that are currently considered banking? For example, securities firms also engage in foreign exchange transactions. Should that advantage be eliminated for those kinds of transactions, as well?

Secretary **Brady**. The advantage being?

Senator **Heinz**. The advantage being low cost deposits and the problem being that this is an area where banks are already operating.

Secretary **Brady**. I see. Your point is to take the narrow field of foreign exchange——

Senator **Heinz**. Let me come down to cases. If the idea is that you want to have a separate subsidiary of some kind to do securities transactions, what you might call in the broadest sense nontraditional banking activities, to segregate it either by a firewall, a Chinese wall, separate capitalization, whatever is decided, and you put into that normal securities operations whatever they may be, whether it is equity underwriting, mutual fund underwriting, should you also put into such a subsidiary things that banks are now doing that are now under current interpretations of the law properly incident to banking? Should they go into that kind of a subsidiary, as well?

Secretary **Brady**. Well you have stated the problem, Senator Heinz. Again, I think before you came here I apologized to the Chairman for not having answered all of these questions, but I cited the fact that we are going to produce a study at the end of this year and be precise on it.

Senator **Heinz**. If you want to take the Fifth, that is all right. I do that myself sometimes.

Let me just ask you one last question, if the Chairman will permit. It is this:

In your testimony on page 21 you point out that a number of economic factors have contributed to the competitive decline of U.S. banks. Two of those factors relate to our low savings rate and our high cost of capital. As you know, it has been reported that the budget summiteers, and allegedly the administration, and even possibly you, have been considering a tax on stock transfers as a good way to raise capital.

What impact, in your judgment, would a stock transfer tax have on the cost of capital?

Secretary **Brady**. Senator Heinz, again I am going to take the Fifth because that question was asked earlier.

Senator **Heinz**. If it was, I apologize. If that question was asked earlier, I apologize. Was it answered? [Laughter.]

Secretary **Brady**. No. If you prefer—Chairman Riegle, if you would allow me——

The **Chairman**. By all means.

Secretary **Brady**. Senator Heinz, you referred to the items on page 5 which are listed to explain the relative position that U.S. banks have in the competitive world. I would add that my testimony also includes—and I do not see it in this list—the fact that other countries of the world view their commercial banking system as a national asset, and they take steps with regard to protecting that national asset that are not necessarily duplicated in the United States.

It has been said that because of the low cost of capital in Japan, Japanese firms have an inherent advantage in competing with United States banks. I do not think we should look at the performance charts of how the United States banks have done in world competition without realizing that there is a strategic decision made by other countries to have their banks strong, and that they have, instead of an adversarial relationship with their Government, they have one that is much more supportive than it is here. I am not talking about Congress as opposed to the administration—but as the world of weapons, nuclear and conventional, decreases the standard by which nations will compete with each other, economics is going to come into the forefront.

We should be concerned. That is why I joined with Senator Riegle in thinking that we should take a really hard look and do something in 1991 about the status and strength and vitality to compete with our banking system. We have a tendency in this country to view our banking system on an adversarial basis. That is not true in Germany and Japan, and some of the people we compete with. We have to take that into account as we view their performance in international statistics and comparisons.

Senator HEINZ. Mr. Chairman, if I may just respond, I think the Secretary makes a very good and important point with which I fully agree. Indeed, I do not think that we would have had the kinds of controversies either within this committee, or particularly between the House and the Senate. The Senate, as you know, has twice passed financial restructuring legislation which has not been reciprocated on the House side.

Notwithstanding that, I think if we did not have the particular kind of safety net, particularly Federal deposit insurance, that we would all have agreed long ago to let all the financial services firms and banks compete without us injecting ourselves and setting up strictures and walls that date from 1931, 1932, 1933, 1934. But that decision in the wake of the depression, which still hangs over us and which we are still trying to cope with, was a series of decisions—the Securities Act, the Federal Home Loan Banking Act, the National Banking Act—and so forth, to protect those institutions, to protect depositors, to restore confidence in our economic system, to our financial depository system, to, in effect, protect the firms' capital bases themselves by restricting competition.

That is what those laws all did. The task we have—now, because of the S&L problem that we find ourselves confronting, is how to make our financial institutions competitive both domestically and internationally. It is a very well-taken point.

We are trying to deal with more nearly 60 years, of our history and conforming it to dramatically changed circumstances in the world. That is why we are delighted you are here, and your testimony is so valuable.

Thank you. That does not mean you have been necessarily in the industry for 60 years. [Laughter.]

The CHAIRMAN. Let me just say at this point, I know the Senator is interested in another round. I would like to ask another couple of things myself. I am mindful of the time. I want us to get ahead of this curve, and I want us to get ahead of Europe 1992 in terms of hitting this window in 1991. I think we can do it. It is not simple, because we have run into these jurisdictional issues in the House, and what have you, but I think if you folks in the administration decide that this is one of the top four or five priorities that are going to get done in 1991 and we join you here, and I fully intend that we will—certainly I will, and I think certainly the committee will as well. That is why we are laying all this foundation. I think we can get it done and get ahead of the curve.

I think that is really the requirement, to move in front of events and not always lag behind them.

Let me go back to an issue Senator Heinz touched on a minute ago. When Alan Greenspan was here just a few days ago at the witness table, he indicated that this money supply adjustment that they had made at the Fed was essentially a one-shot deal based on what they have seen in their data in the way of credit-tightening.

In his view—and I will not try to give you the precise words, although I read it again this morning so it is clear in my mind—he was trying not to nudge interest rates lower, as such, but he was trying to adjust the credit tightening that he felt perhaps had gone further than it should have in terms of enabling the monetary and policy goals to be met.

Therefore, one should not assume that there should be a second or third adjustment unless new data was forthcoming to show, you know, a worsening situation in terms of credit availability. We discussed that with him at some length. So it is not a skimpy committee record; it is quite complete on that point.

Do you agree with that? Has the Fed gone far enough here? From your vantage point, which is obviously different, do we need to see something more done in terms of nudging interest rates. You have got a different look at this thing.

Is what has been done sufficient, or do we need a little more?

Secretary **Brady**. Chairman Riegle, I would only say that we welcome the change that was made. I made a statement on the record which I have not done in the 2 years I have been at Treasury, in the last month or so. It basically said we are all part of the same country. There is a Federal Reserve System. There is an administration. There is a Congress. We all have a common goal. To separate us into camps where one of us is an armed guard looking at inflation and others of us are armed guards trying to produce growth I do not think helps the understanding of the problem.

I choose to think that, with the numbers which have come in in the last 6 months which show a slowing down in the economy in the United States, we all should look again and rejoice in the benefits that have come from eight years of growth with a higher standard of living, and more jobs for working people. So perhaps people in the administration and I would think probably Congress spent too much time thinking about that.

On the other hand, the Fed—or perhaps it is just that they get asked questions about inflation all the time—has a special responsibility to look at inflation. However, when growth in this country slows down as it has, I would just repeat my statement. We are all part of the same country. We should all have the same end goal.

The **Chairman**. We got a statement from Secretary Mosbacher not long ago where he expressed a very direct concern about what he saw as a credit crunch developing out there, and he was expressing some heightened concern from his look at the commercial side of the economy, which is the growth side of the economy.

We have not had a chance to ask you that question. Do you sense that we have got a credit crunch out there? And is it something we need to make an adjustment for?

Secretary **Brady**. We certainly have two things. We have fewer applications for credit. I would have to listen to the comments that people have made to me, which I am sure are the same ones you have heard, about regulation being more strict than it has been in the past. I do not know whether the level of interest rates has too much to do with the credit crunch, so-called. I think the credit crunch results from other things.

Perhaps some of it is regulators looking back at the past and what happened in the S&L industry—and a lot of this credit crunch is in the real estate area—and not wanting to have the same thing happen again. So maybe those standards are the same, but the situations in which they are being presented—fewer good projects because of real estate oversupply—do not qualify as well from a regulatory standpoint.

Chairman Greenspan said in his testimony that a commercial bank loan officer, when presented with a loan application 2 years ago when growth was greater and the real estate situation was less severe, probably would have made a loan that he would not make today. So I think it is a combination of circumstances.

I do think that there is a credit contraction, whether from fewer applications or more regulation, and in what amount, I cannot give you an answer. But the Chairman, I think in lowering the Federal funds rate from 8¼ to 8 percent, referred to that credit crunch. So it is there. Hopefully it will pass through the system in New England like it did in California and Texas and we can get back into a growth pattern.

The CHAIRMAN. From your vantage point, would it be fair to say then that you are satisfied with what our monetary policy is right now?

Secretary BRADY. Obviously, Senator Riegle, the job of regulating monetary policy is the Federal Reserve's particular province. I would just make again the elliptical comment that I have made in the past, which is that we are all part of the same country.

The CHAIRMAN. I am not going to press you further on it, but I think it is important that if you have a concern in that area—and I do not presume that you do or you do not—but if you have one, I think you need to have an opportunity to express it in a place where it can maybe have an impact.

So having had that opportunity——

Secretary BRADY. I have said before, and I do not want to bore you by repeating it, that the administration is perhaps—not "perhaps"—is concerned with growth, for the reasons we just went through. And whether or not a heightened worry about inflation at this particular point in time is warranted at a time when we should be worried more about growth, I would question that.

But that is as it would be, as it is. I would only point out one thing with regard to inflation, that a good part of what the calculations on inflation show is that this inflation is in the services' area, health care costs and the like. Health care costs are very hard to control. I do not know whether increasing or decreasing monetary aggregates would or would not change health care. I think health care is part of a way of life in this country, and it is going to continue to go up as benefits are put forward.

So I do not know as we ought to measure that when we measure whether we have too much inflation or not.

The **Chairman**. I am going to ask you one other question here. I could pursue that, but I will not at this time.

We sent a letter to you, three of us, Senator Byrd representing the Appropriations Committee; and Senator Sasser the Budget Committee; and myself as Chairman of the Banking Committee, about the speedup in resolution activity in the RTC and whether we are going to have enough money left to get us through the fiscal year.

I am wondering, as you are here today late in July and looking out through the end of the fiscal year at the end of September, will more funds be needed prior to that time? It looks like you may need more, or at least it will cut very tight. Can you give us a sense?

Secretary **Brady**. Yes. There are two types of funds that the RTC requires. One is loss funds which are being booked on assets that come under the resolution process in the RTC. The other is the working capital funds that are needed in order to carry the assets that are temporarily housed there and will be sold at a later date.

The calculation with regard to losses would indicate that we will need more money before the end of the calendar year, sometime late in the calendar year 1990.

With regard to the need for working capital, and based on the increased speed of resolutions that the RTC effected in the second quarter and their operating plan for the third quarter, it looks as though we will need more working capital soon after September 30. It is both Congress and the administration's goal to give to the RTC the amount of funds they need in order to continue their operations. I do not think anybody is suggesting that they slow down in the cleanup process.

So we have to face the problem about working capital while Congress is in session. With regard to the losses, we do not have to face them until the end of the year. But if Congress adjourns sine die in October, those loss requirements which will exist after they have gone, will probably have to be taken care of as well.

With regard to working capital, we do have in the legislation $18.8 billion which would allow us to generate additional working capital by using that formula. There is some concern that that is not in conformity with what the FIRREA legislation contemplated when it was put forward, but it may be that Congress and the administration will want to take advantage of that particular provision in order to provide the working capital.

The **Chairman**. We will have to discuss that. I think what is important here with the rate of activity having accelerated, I want to make sure there is going to be enough money available to get the job done on a timely basis. So I would hope that the minute it is clear what the needs may be in this fiscal year on the working capital side, you will let us know so we can make sure that we do not get trapped against a deadline that is too close to us and we cannot get the job done properly. I think we really need to be given early notice.

I realize this is not an exact science, but I think if we are going to need a request for more money, I think the sooner we get it the better equipped we are to handle it on an orderly basis and get the job done.

Secretary **Brady**. As I said, it looks as though the working capital requirement will need increased funds as early as October. The problem is, even if it is early October, we will deal with it as quickly as we can. As I say we have this $18.8 billion which will allow us to go ahead and fund that requirement. Perhaps that is what we ought to do.

The **Chairman**. Let me just leave it this way. I do not know whether we are going to finish our work and adjourn sine die, or have a post-election session. Those are questions that cannot be answered right now. But the thing I want to do is I want to make sure that as you are carrying out the work of the RTC and the other implementing activities that deal with this problem, that the resources you need to get the job done are there, and we do not run into a snag where all of a sudden you cannot function, or some part of the organization cannot function.

So I would ask that some considerable effort be given here to really pin down the estimates that will be sufficient to solve this problem both in this fiscal year prior to September 30 so there is no interruption there, and also that we anticipate the period of time that the Congress will be out of session prior to the start of the next session of Congress. So that whatever you appropriately need, we can plan for and make sure is in place so you get your job done.

Secretary **Brady**. I understand.

The **Chairman**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

I just want to pursue a couple of questions, one of which you were discussing. I made the statement that the savings and loan loss could represent 1 percent of the gross national product. I recognize it is difficult to determine the most appropriate way to account for that.

There was an article in The Washington Post on July 21 which talked about the immense importance of how to account for the S&L cleanup as part of the overall budget resolution. I would like to ask three questions relative to that.

First, in 1989 in terms of financing the S&L bailout, we reached a compromise that put $20 billion on budget and $30 billion off-budget. The article in The Post uses the phrase "off-budget borrowing had tended to be more expensive than normal Government borrowing and thus increased costs of the thrift clean-up."

The article goes on to say, " 'It is unlikely that the administration will back additional off-budget borrowing to meet the S&L costs. That is what the technical experts call a sham,' said one administration budget writer, 'and the administration is not going to impose another sham.' "

Do you anticipate that any future recommendations of the administration will in fact be for funding on-budget?

Secretary **Brady**. They will be on-budget. I do not agree that it was a sham in the past.

Senator **Graham**. No. 2, when I last checked——

Secretary **Brady**. The way to get private funds into this process is the way we did it.

Senator **Graham**. When I last checked, the amount of unexpended funds from that $30 billion off-budget was $17 billion. That number may be lower.

Secretary **Brady**. I think it is $12 billion now, Senator Graham.

Senator **Graham**. Would you recommend that the remaining balance, $12 billion or whatever it is, should be placed on-budget?

Secretary **Brady**. No.

Senator **Graham**. Third, in terms of calculations for Gramm-Rudman-Hollings, focusing on three aspects of the S&L bailout, one is the administrative and interest costs which OMB calculates to be approximately $10 billion, to what you would call the losses or the sunk costs, those costs that are not going to be recovered; and third, working capital, which if any of those do you think ought to be included in calculating the deficit for Gramm-Rudman purposes?

Secretary **Brady**. I believe the deficit for Gramm-Rudman purposes has to include any outlays of funds. I do not believe that we have any ability to change that, one way or the other, unless you change Gramm-Rudman.

Senator **Graham**. As a matter of policy, does the administration have a recommendation as to which, if any, of those three they should include?

Secretary **Brady**. What we are talking about, if the Gramm-Rudman law is changed, is whether or not the S&L cleanup expenses should be included in the calculation. I can tell you what the discussion has been in the summit.

There are those who feel it should be included. There are those who feel equally strongly, and I think they are in the majority, who feel that the amount of money for the cleanup will so complicate and confuse that they should not be part of the process, particularly with respect to working capital with the increase in funds needed. I think the gentleman from CBO said yesterday that in 1994 it would be some $25 billion of funds coming back in again.

So in effect, it would increase the budget deficit in one year, but as working capital is liquidated it would decrease it in future years thereby presenting a false picture.

I think most of the people in the summit feel there is no point in taking a complicated process and making it more complicated by including those calculations in the targets. There are some who feel otherwise.

Senator **Graham**. Is the administration position then that working capital should not be included in the Gramm-Rudman target calculations?

Secretary **Brady**. I think it is confusing.

Senator **Graham**. The answer is, it is the administration's view that it should not?

Secretary **Brady**. If that is the way we are going to work it, it will be worked out that way.

Senator **Graham**. What is the administration's position relative to the administrative costs and interest which it calculated to be $10 billion. Should that be included in the Gramm-Rudman?

Secretary **Brady**. I believe the administration—I think they should be included in Gramm-Rudman.

Senator **Graham**. The losses are sunk costs. That is, the difference between what it costs to hold depositors insured and the recovery of assets, the sunk costs of assets, should those be included in Gramm-Rudman?

Secretary **Brady**. I think to a lesser degree that the people in the summit feel that that again has the effect of swinging the Gramm-Rudman targets around in a way that is confusing and not necessarily helpful in trying to reach a conclusion to the summit because there is going to be an end to this problem, and it ends sometime in the early 1990's. So that as you reduce those, as the problem becomes less and you look at those deficits coming down, and in effect the structural part of the deficit, that should really be dealt with in the difference in entitlements and revenues and that sort of thing is obscured by putting this particular loss amount in the budget calculations.

It also presents Congress and the administration with a problem of dealing with a moving target. You say it is going to be, say, $100 billion, and the real estate market gets worse so it gets to be $120 billion. So we have to come back and get more funds and go through the calculations again. Contrarywise, if it were less and there is a windfall, it should not be portrayed that way.

So I think it is a strong and powerful argument for leaving it outside the budget calculations.

Senator **Graham**. Returning for a moment to the issue of the $12 billion which is left in the off-budget calculation, if the administration position is that it will not recommend any additional off-budget funds for the cleanup, and if it is agreed that the financing for off-budget had been more expensive than normal Government borrowing, what is the rationale for continuing to borrow off-budget and not move that $12 billion into an on-budget status?

Secretary **Brady**. Because if the industry funds used in that system of financing the S&L cleanup are to go back to those people who created the problem in the first place, the S&L industry would be retaining funds at the expense of taxpayers who would then find the entire bailout. The industry should be required to pay for some part of the problem, as much as they could afford and still have a viable industry. It is important that we take those funds from the people who created the problem and use them to pay for the cleanup. I think we ought to leave that in place exactly as it is.

Senator **Graham**. But you do not recommend doing that in the future?

Secretary **Brady**. There are not any more funds left in the S&L industry to do that. We have put on that industry a burden which is as much as they can bear at this particular point in time.

Senator **Graham**. My last question goes to your response to a question I asked about what were the changing circumstances from January 31 to July 25 that occasioned these different economic circumstances.

You cited two: the slowdown in the economy; and excessive spending. Since the budget that the President submitted is for the fiscal year that begins October 1, 1990, that was the budget to which he was referring in his January 31 State of the Union Address. To date, no appropriations bills have been sent to the President that would implement that fiscal year 1991 spending pattern.

Where are the areas of "excessive spending" that have caused the difference from January to July in these economic circumstances?

Secretary **Brady**. I would be glad to provide you with a list, Senator Graham, and I will do so. I do not have it at my fingertips. All of the bills that are before us—I have one in mind—will turn out to be 1990 bills. The President asked for $18 million to put Panama and Nicaragua back on their feet, and it had $3.2 billion of domestic spending added to it. So that would be the kind of thing that I am talking about. But I would be glad to provide you with a list.

Senator **Graham**. Thank you, Mr. Chairman.

The **Chairman**. Secretary Brady, I want to say again that I appreciate the content of the statement that you prepared and delivered today to the committee. It is very helpful to us.

I will want to submit to you some questions for the record from members of the committee who were not able to be present this morning. You should know that the Farm bill is also on the Senate Floor this morning and is up for debate, so other members are occupied there.

I want to finally say this. I want the room to be quiet until we adjourn here. That is, I think that we have had, this committee and you and your office, an exceptionally good relationship in terms of working on some complicated and difficult issues in the time that we have each been across the table from one another. This goes back to January of last year.

I think in coming down through the savings and loan reform legislation where we had some differences here and there we were able to reconcile, for the most part, those differences and we were able to put in place a very strong package. It is being carried out at the present time, and there is a lot of work left to be done. The same with other issues that have arisen since that time.

As it relates to the subject matter today, I think there is an opportunity, and I think there is a very compelling necessity that we tackle this financial modernization issue and get it hammered out and work our way through whatever the obstacles are.

I think in order to really get the momentum and break through whatever institutional and other barriers there might be, it has got to be something that the administration really wants to do and is really harnessed to do.

I just want to say to you again that this committee is determined to get it done. We cannot get it done by ourselves any more than you can. We have got to do it in tandem. I think we know how to work together, and I would like to suggest that we make a decision early in the game here that we are going to get it done in 1991; that we are going to get the United States' positioned to face off against this rapidly changing global economy, and put ourselves in a strong position to go through the last decade of this century and on into the next one.

I think we can get it done if we approach it that way and it gets that kind of priority. So my commitment here, publicly and to you, is that we will harness the resources of this committee to get our part of the job done. That is why we have had these hearings this year.

We will be putting proposals on the table at some point with respect to deposit insurance and perhaps other aspects of this, but we want to work with you to craft a package where give-and-take can take place early in the game and get some momentum and go ahead and get this job done, and give the United States as a whole and our economy the kind of positioning and the kind of fighting chance to be able to go out and take on the rest of the world and do it successfully.

So that is an offer that I make, and I hope that we can sort of proceed in a kind of partnership with the administration on that basis, because I think if we do it that way and give it that kind of priority, we can get it done. I do not think it will get done any other way.

Secretary **Brady**. Chairman Riegle, I welcome those remarks. We feel equally strongly that it looks to us as though 1991 will be the time in which these matters could be properly addressed and changed, as the record seems to indicate.

The **Chairman**. Very good. I appreciate that. Thank you for your testimony. The committee stands in recess.

[Whereupon, at 12:30 p.m., the committee was adjourned, subject to the call of the Chair.]

DEPOSIT INSURANCE REFORM AND FINANCIAL MODERNIZATION

TUESDAY, JULY 31, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Garn, Dixon, Heinz, Graham, Wirth, Kassebaum, Sanford, D'Amato, Bond, and Mack.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The **Chairman**. The committee will come to order. We want to welcome especially our witnesses today, and I'll have something more to say about that in a moment, and everyone else in attendance.

Today the committee will hear testimony from FDIC Chairman, William Seidman, and Comptroller of the Currency, Robert Clarke, on the subject of financial modernization on deposit insurance reform and the international competitiveness of our financial institutions.

The committee has now heard testimony from representatives of the banking, insurance, real estate, and securities industries; from consumer groups, from academicians, from Federal and foreign bankers, and most recently from the heads of our financial institutions regulatory agencies.

This series of hearings now that have stretched over the better part of the year have laid the groundwork for the committee to consider specific legislative proposals. And we hope those proposals will be forthcoming later this year, early in 1991, as part of the administration's deposit insurance study.

If we intend to consider deposit insurance reforms in the next Congress, as I think we should and have indicated many times in the past, our efforts need to begin as early as possible, either late this year or, at the latest, early next year.

This morning, we'll be particularly interested in hearing from a regulator's point of view whether our current system of deposit insurance encourages excessive risk-taking, whether the current supervisory system can cope even with existing risks, and whether the current regulatory structure needs consolidation or restructuring, and, finally, whether new powers should be granted to banks or their affiliates and, if so, what tools the regulators feel that they would have to have to effectively supervise any new powers of that sort.

We're going to hear first from Mr. Seidman and then from Mr. Clarke, but I want to just make a couple of personal comments about Bill Seidman.

First of all, I want to say all of us are happy that you're recovering as well as you are from that very unfortunate and serious mishap that you had out west. But, more than that, I want to say on behalf of this committee, and I want to say personally as the chairman how much I appreciate the job you're doing and the job you have been doing over a long period of time and its importance to the country.

We're working our way through some difficult problems, and having skilled, independent leadership able to help chart that course, I think, is very important to the country. You provide that, and that's something we need, and, if anything, we need more of. And so we value your service and your hard work, and I just want to say that at the outset.

And I also want to say that we'll be getting into some other subjects today here. Obviously your testimony on the size of the financial requirements in the S&L problem are very important to us, as well. And so after we've gone through your testimony today, we'll want to get some of your thinking on that topic and, perhaps, other related topics.

Senator Garn?

OPENING STATMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

I certainly want to echo what Senator Riegle said we're happy to have you back with us in such relatively good shape compared to what you were a few weeks ago. I did warn Chairman Seidman that riding horses was a lot more dangerous than flying in space, but he didn't take my advice. But we are pleased to have you here.

I do look forward to the testimony of both of our witnesses today. Given their preeminent roles in the supervision and insurance of commercial banks, they are unquestionably among the most authoritative witnesses we will hear on the questions of bank regulation and deposit insurance reform. These gentlemen and the agencies they represent will certainly play a crucial role in the ultimate success of our restructuring efforts.

Throughout this excellent series of hearings on modernizing our financial system, many of our witnesses have advocated repealing or revising banking laws such as the Glass-Steagall Act, the McFadden Act, and the Douglas Amendment to the Bank Holding Company Act.

Witnesses have testified that these laws restrict growth, hamper competitiveness, and, to some degree, threaten the long-term safety of our financial system. While there seems to be a developing consensus on the need for financial reform and even the general provisions required, we must now begin to focus on specific questions if we are to have a realistic chance at major reform in the Congress.

For example, most are agreed that we should dismantle the already-crumbling wall that's crumbling in the marketplace between the banking and securities industries. What remains to be determined is what should replace it.

Questions like, is the insulation provided by sections 23(a) and 23(b) of the Federal Reserve Act, governing interaffiliate transactions sufficient to protect depositors and the insurance funds, or should stronger firewalls be considered, ones that limit information flows, shared officers, logos, names, and even office space?

On the other hand, we must consider whether strict firewalls might hamper the very synergies that form much of the justification for financial restructuring. What this committee must endeavor to achieve is the appropriate balance between safety and soundness and competitive efficiency.

Mr. Chairman, this series of hearings has laid the groundwork for legislative action. I look forward to working with you and our colleagues and Mr. Seidman and other members of the committee to finish the full framework for financial restructuring next year.

And, as both of us have said, it's certainly not realistic or possible this year, but I do think the hearings that you've conducted this year will lay the groundwork for some action in 1991.

Thank you, Mr. Chairman.

The CHAIRMAN. Very good. Thank you, Senator Garn.

I think we'll go next to Senator D'Amato, and then to Senator Wirth.

Senator D'AMATO. Well, Mr. Chairman, I'm just going to ask that my statement be included in the record—good to see the Chairman back—as if read in its entirety so we can hear the testimony of the Chairman.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, today the committee concludes its series of hearings on financial services modernization. I would like to congratulate the chairman for holding these hearings, which have provided the committee with valuable information regarding financial modernization and a good background for developing legislation early next year.

Today, at the last hearing of this series, we will hear from the Chairman of the Federal Deposit Insurance Corporation, William Seidman, and the Comptroller of the Currency, Robert Clarke. I join you in welcoming these witnesses and look forward to their testimony.

Much of the testimony that we have heard during these hearings has highlighted how changes in the domestic and international financial environments have forced us to re-examine the current legal structure of our financial services industry and to consider ways to reform it. Our witnesses have reaffirmed that there is a need to update our financial institutions, and have commented on the need to modify our deposit insurance system and to grant banks additional powers.

Now we have two of the chief regulators of the banking industry here to discuss their assessment of our current banking system and their analysis of various proposals to modernize our financial institutions. I am especially interested in hearing Mr. Seidman's comments on the current state of the FDIC and the overall health of our banking system. In addition, I am hoping that we might learn more about the role of banking regulators in the "credit crunch" that New England and other areas are now experiencing.

Thank you, Mr. Chairman.

The **Chairman**. Very good. Senator Wirth, do you have opening comments that you'd like——

Senator **Wirth**. Mr. Seidman, we look forward to having you today. I thank you very much for coming.

Senator Graham and I have long been pushing the issue of reform of deposit insurance and the institutions doing that. We look forward to your views on that, and also, with your experience now in this whole S&L business, you know, how far—what have we learned from this and how far do we want to go in the area of deregulation of other financial institutions, what safeguards do we set up?

I mean, you're probably the best and most credible person in town to talk about that, and I look forward to hearing your testimony. Thank you for being here.

The **Chairman**. Very good. Thank you, Senator Wirth.

Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman. I, too, am delighted to see Chairman Seidman back and wish him continued success in his recovery.

Having looked at the very thought-provoking comments of Chairman Seidman and Mr. Clarke, I think we would gain a lot more by listening to them and I will pass on an opening statement.

The **Chairman**. Very good. Senator Mack.

Senator Kassebaum.

Senator **Kassebaum**. I will only ditto the remarks of the Senator from Missouri to say welcome and I'm anxious to hear what you have to say.

The **Chairman**. Very good.

Chairman Seidman, we'll make your full statement a part of the record, and we'd like you now to give us the summary comments that you think we need to hear.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Chairman **Seidman**. Thank you, Mr. Chairman. Thank you very much for your kind comments by you and other members of the committee. I appreciate the opportunity to be here today. Especially in the light of recent experiences, I appreciate being here to comment on deposit insurance and financial reforms.

And I can think of no subject that is more important to the future of our economy than the subject we are asked to talk about today. So let me give you my thoughts on what we need to do to change the financial system.

First, I think our objectives in reforming the system should be, one, to reduce the potential liability of the Government for its safety net and, particularly, as an insurer of deposits; second, to maintain the stability of the financial system as the deposit insurance system has done so well in past; and, third, to increase the market orientation of the system so that we have a system that is competitive and consumer-oriented.

The foregoing is all we need to do to vastly improve the performance of the financial system of the United States. And it's all we need to do to improve the ability of our financial institutions to compete successfully in the work economy.

Surely, one would think, with all the experience we've had with the S&L debacle, the tons of academic research provided to us, and the practical Yankee know-how which we have inherited, it should be possible to promptly proceed toward meeting these relatively simple and well-defined goals.

But, as we all know, political history indicates that it will not be easy, because reasonable people disagree on what should be done. And further disagreement will be based not only on intellectual analysis, but economic interests.

Still, we must proceed to debate the issue to the point of action. As you know, the Treasury is conducting a review of these issues, and we are participating, so my remarks are presented in the context of being a participant in that ongoing process.

What follows is the shortest of short-form outlines of our thoughts on this important subject. These thoughts may be jumbled by the recent efforts of my good quarter horse, Primero, but, then again, perhaps his causing a little brush with mortality could help me to focus on the process.

So let me again refer to our major objectives. First, we must find a way to reduce the potential cost of the Government's pledge to insure financial deposits. The present system is simply a bad bet for society. It can cost too much for the values received.

To reduce the potential cost of insurance to the taxpayer, I would propose a threefold approach. First, on the asset side, we need to limit the kinds of investments that can be made with insured deposits. Only the kinds of investments that experience indicates are reasonable, conservative, and safe should use these insured deposits for funding.

Other ventures such as low-grade loans, direct investments, out-of-territory lending, nonbank related activities, should be funded by the market with no Government guarantees. This should be done in separately capitalized entities, whose failure will not jeopardize the bank, the insured bank, because by law the bank cannot be held liable for their activities and because their separate entities are not counted as part of the required capital of the banks.

In large institutions, this should be relatively easy to do. In small institutions, separate rules may be required. So the first of my threefold approach is on the asset side and deals with what insurance funds can be used for.

Second is on the liability side, and deals with the exposure of the Government and how it can be reduced by reducing what it is the Government agrees to insure. This means the "too big to fail" concept, 100 percent deposit insurance for large institutions, must be re-examined and restricted.

But, in my view, this can be done only on an international basis. As you may know, we have a conference on this subject planned for this fall at which we've asked a number of the major countries to participate and discuss with us this really worldwide problem of the "too big to fail" doctrine.

Further, we must look at insurance coverage with an eye toward restrictions on the amount of liability per customer. This reduction, for example, could include required coinsurance above certain minimums, reduced insurable amounts, or limited numbers of insured accounts per person, elimination of pass-through insurance, and other means of restricting liability.

In my view, none of these changes on their own will really make a big difference, but all should be explored as possible methods of chipping away at the Government's exposure in reducing its liability. So the second approach is to look at the liability side and reduce what the Government insures.

And the third part of the approach in on the structural side, making structural changes to achieve our goal of reducing liability. More capital, risk-based premiums and capital, and private coinsurance all have promise in this regard. Most important is to evolve a structure that separates insured deposits from risky ventures by using legal separate entities with legal assurance of separateness, as I've mentioned before.

Now this is not firewalls in the sense of restricting intercompany activities such as common name and so forth, but assurance of a separate legal entity for legal liabilities so that, in fact, the insured funds are not jeopardized by the failure of these separate entities.

So, as I've said, we must look at assets, liabilities, and structure to find ways to control potential insurance costs.

Now the second objective is one of continuing stability. We must make our changes in a way that do not jeopardize the costly and hard-bought stability that we have brought to our financial system. I would remind you that 9 out of the 10 largest banks in Texas failed or would have failed without our or other help. And the same can be said of 2 of the 3 largest banks in Oklahoma.

And, at the same time, hundreds of other banks were failing, and yet the system did not panic into collapse, although we certainly had some runs that were stopped by the safety net.

So our changes to reduce costs must be done in a way that meet the objectives required for stability. What are these objectives?

First, the average depositor must not be put at unreasonable risk for the common and ordinary small deposit.

Second, the method for handling large institutions must allow those with responsibility to handle them to be in a position to handle them in a way that does not destabilize the system.

And, third, the Government must always be able to act to meet problems in the financial system where necessary, and the tools to do this must be in place before the crisis begins.

Now our third objective is to create a system that can operate safely—our third objective is to create a more competitive system. A system can only be safe and sound if it can provide a competitive service to its customers and make a reasonable profit.

To make this possible, our system needs to, first, eliminate unnecessary restrictions on products and services. Glass-Steagall must go, with safeguards in place that assure that insured deposits don't fund the new activities.

Second, eliminate the Bank Holding Company's regulation of capital requirements. The separateness of finance and commerce must go. The Bank Holding Company Act generally increases regulatory costs, reduces available capital, and creates the most awkward and expensive structure that exists anywhere in the world.

Third, eliminate geographic restrictions so that our institutions can compete as truly U.S. institutions rather than just New York or regional entities. This change can be put in place while retaining the flexibility and decentralized merits of the dual banking system.

Now, finally, with respect to changes in the regulatory structure as against the substantive operations of the system, that is, who regulates what, I believe restructuring here should be based on the financial system that will evolve from the reforms that will be made.

A reformed financial system, in my view, comes first. A regulatory structure to fit that new system comes second. However, as a general guideline, experience indicates that the independence of financial regulators and insurers is essential to accomplish the task of supervising the financial system without bowing either to the current political fad or to potentially large economic pressures.

Further, bank supervisors should not be put in any conflict of interest by being responsible for other important public objectives, such as monetary policy, international economic stability, and revenue production.

Supervision can be more unified than it is today. But if it is to be more unified, then it is even more important that it be kept independent of other public concerns and political pressures.

Well, that is all I can squeeze in in the time allowed. Let me conclude with a thought, that the importance of getting on with these changes in our financial system cannot be overstated. And, as I said, I truly believe our economic future to a substantial degree may well depend on improving the performance of our financial system.

Thank you.

[The complete prepared statement of L. William Seidman follows:]

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

DEPOSIT INSURANCE REVISION AND FINANCIAL SERVICES RESTRUCTURING

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
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Mr. Chairman and members of the Committee: We appreciate this opportunity to testify on the need for legislation to modernize the regulation of financial services. There is no doubt in our view that change is necessary to enhance the competitive position of financial institutions and reduce the exposure of the taxpayers to the costs of the federal safety net. In the invitation to testify, we were asked to focus on three interrelated issues. These are:

(1) How should the current system of Federal deposit insurance be reformed?

(2) What should be done to improve the current Federal regulatory structure? What changes in Federal supervision would be needed to deal with expanded powers?

(3) Should new powers be granted to banks or their affiliates? If so, what powers should be granted, when should they take effect, and with what protections for the deposit insurance fund? Should new powers be granted only to a bank's holding company affiliates, rather than to the bank or its subsidiaries?

Our testimony on these very broad, complex issues does not contain definitive recommendations. Along with the other federal banking agencies and the Office of Management and Budget, the FDIC is participating in the Treasury Department's comprehensive study of deposit insurance. This study was mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Treasury intends to complete the study by the end of this year.

Because the study will draw conclusions and make recommendations regarding the subject matter of this testimony, providing final conclusions and recommendations now would be premature. Since we are still studying these matters with our colleagues, our purpose in this testimony is to report on our thinking and define the important issues we believe are involved.

In laying out the issues, our testimony first reviews several general considerations that should be kept in mind when the topics of financial industry and deposit insurance reform are examined. Then issues involving structural reform of the deposit insurance industry are discussed. The topic of structural reform concerns obstacles to the maintenance of a healthy banking system. In the final analysis, a healthy deposit insurance fund depends on the viability of the banking industry itself.

Next, suggestions for reforms in the deposit insurance system are considered. Although the deposit insurance reforms are important, the point needs to be emphasized that in the long run they would be ineffective if the structural problems of the industry are not addressed. The United States has operated for far too long with an economically irrational financial structure. Financial institutions need freedom, subject to adequate supervision, to respond and adjust to changes in the competitive environment.

The testimony concludes with a brief look at the topic of changes in the federal regulatory structure.

BACKGROUND

To say that the last decade or so has been a period of change and turmoil in the financial industry is, if anything, an understatement. Secondary evidence of the volatile environment and its effects on various segments of the financial industry can be found in the actions of this very body. Since 1978, Congress has passed an extraordinarily large number of far-reaching laws pertaining to depository institutions.

These laws include: The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA); the International Banking Act of 1978; the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA); the Bank Export Services Act of 1982; the Garn-St Germain Depository Institutions Act of 1982; the International Lending Supervision Act of 1983; the Competitive Equality Banking Act of 1987 (CEBA); and most recently the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

What is the point of this mind-numbing recitation? The point is to emphasize the many rapid changes that have taken place in the financial environment, changes considered serious enough to warrant action by Congress. Never before in the nation's history, not even during the legislatively prolific years of the 1930s, have such a large number of important banking laws been passed in such a relatively short period of time.

And many contend that an appropriate point for a legislative hiatus has not yet been reached.

In hindsight, some of the actions--both legislative and regulatory--taken during the last decade appear unwise. As a general matter, the deregulation of the savings and loan industry was not accompanied by a concurrent strengthening of capital standards and the industry's supervisory structure. This contributed to the S&L crisis, a financial disaster of major portions.

Among the lessons that should be absorbed from the S&L debacle is that adequate supervision is necessary to the maintenance of a safe and sound system of depository institutions. Regulation--the mere promulgation of rules--is no substitute for supervision because the rules must be enforced. And the nature of the business of depository institutions is such that enforcement requires judgement and hands-on efforts by competent, trained examiners.

In determining what additional banking laws should be added to the prodigious output of the recent past--either to cope with problems that have not yet been adequately handled or to correct prior efforts--several considerations need to be kept in mind. These are: (1) the changing nature of the banking industry in the nation and the world; (2) the uniqueness of the problems in the S&L industry; and (3) the misunderstandings concerning the Too Big To Fail concept.

A Changing Industry

Reform of the deposit insurance system must begin with reform of the antiquated legal structure burdening the financial industry in general and the banking industry in particular. Reform of this structure is necessary because the competitive environment within which banks operate is changing significantly. Banks and other financial institutions have been hampered in their ability to adjust to the changes.

In Appendix I, a number of tables and graphs are used to identify three interrelated trends: banking is becoming a riskier, more volatile business; banks are encountering greater degrees of competition; and what constitutes the business of banking itself is undergoing a rapid evolution.

One way to summarize what is happening is to say that the banking industry's monopoly on financial information has been eroding. Credit histories are more widely available. The ability to acquire and analyze economic and financial data has become as ubiquitous as the personal computer. The development of complex financial instruments and strategies is being accomplished internally by an ever greater number of corporations. Consequently, banks and the traditional intermediary function they perform are no longer as necessary as they once were.

S&L Crisis Versus Bank Problems

The savings and loan industry crisis and the difficulties facing the banking industry should not be confused. A unique situation and a particular series of events combined to produced the multi-billion dollar S&L disaster.

For many decades, S&Ls performed successfully the task of funding long-term assets with short-term liabilities. The underpinning of this process eroded in the latter half of the 1970s, however, when interest rates rose to unprecedented heights. As the high rates persisted, the total interest expense of many S&Ls grew to exceed their total interest income, the interest expense rising because of the reliance on short-term liabilities.

In an attempt to mitigate the growing difficulties facing the S&L industry, the federal government and several states relaxed restrictions on the activities the institutions could engage in. Most unfortunately, however, little attention was paid to supervising the exercise of the expanded powers. The results are well known. A number of S&Ls went on the institutional equivalent of a bender, and the nation will be paying the tab and nursing the hangover far into the future.

There were, of course, additional factors that contributed to the S&L debacle. One among them was that the federal S&L supervisor, the Federal Home Loan Bank Board, was not just a "policeman." It was also something of a "cheerleader" for low cost home financing and for the S&L industry, having been given the mandate to encourage local thrift and home financing and to promote, organize, and develop thrift institutions. The incompatibility of the two functions may have hindered the

FHLBB's ability to act objectively as the industry's troubles mounted.

A related problem was that there was in effect no separation between the federal chartering and deposit insurance responsibilities for S&Ls. The federal deposit insurer, the Federal Savings and Loan Insurance Corporation, was under the supervision of the FHLBB. This substantially reduced the possibility that a second independent supervisory agency might apply the objective oversight that was neglected by the first agency.

The closeness between the regulators and the regulated in the S&L industry probably contributed to the ill-advised efforts to protect institutions as the problems deepened. An example of these ill-advised efforts was the relaxation of accounting standards to forestall the recognition of losses. The deviation from proper accounting practices only compounded the developing troubles.

Banks do not have the maturity mismatching problems that S&Ls had in the late 1970s. No change in the banking system has required a large increase of supervisory resources in a short period. The chartering and deposit insurance responsibilities for the banking industry are separate. And although some aspects of bank accounting have been criticized, banks have been required to adhere to generally accepted accounting principles. Thus the difficulties facing the banking industry today are not comparable to the situation that produced the S&L crisis.

The banking laws enacted during the 1980s, particularly FIRREA in 1989, made a number of beneficial changes in the supervisory structure of the bank and thrift industries and added a number of weapons to the arsenals of the supervisors. For example, enforcement powers have been strengthened. Generally accepted accounting principles and higher capital levels have been mandated for thrift institutions. And the federal chartering and deposit insurance functions for S&Ls have been separated.

In summary, the point to be emphasized is that although banking industry structure and the deposit insurance system are in need of reform, the problems are not the same problems that brought the S&L industry to its knees. Consequently, the measures that have been taken regarding the S&L industry should not necessarily serve as a blueprint for legislative action for the banking industry.

Too Big To Fail

Too Big To Fail is an imprecise term that has received considerable attention lately. It concerns one of the more important things that must be understood before meaningful deposit insurance reform can be addressed: deposit insurance reform proposals that do not acknowledge the perception of large banks being Too Big To Fail could result in a shift in the competitive balance between big banks and small banks. The latter would suffer. This would be the case even though the FDIC does not in fact have a Too Big To Fail policy.

The term "Too Big To Fail" is used in referring to troubled banking organizations that supposedly are too large for the government to handle by closing the bank and paying off deposits up to the $100,000 insurance limit. There are many nuances in the resolution methods for troubled banks that are not handled through a liquidation and deposit pay off. To generalize, if the deposit pay off method is not used, a troubled bank resolution is accomplished either by arranging for the bank's liabilities, both insured and uninsured, to be acquired by another institution, or less often by providing direct financial assistance.

Who is aided in the various resolution methods varies. In the past, uninsured depositors and creditors of the troubled bank were benefitted in most cases in which a resolution method other than the deposit pay off method was used. Stockholders and management of the institution were benefitted much less frequently. The FDIC's pro rata power--which was legislatively endorsed in FIRREA and in recent years has been considered for use more frequently--enables it to distinguish between categories of uninsured depositors and creditors under all methods of resolving failing banks.

The Too Big To Fail concept came into prominence with the 1984 assistance package arranged for Continental Illinois National Bank and Trust Company. As a result of the assistance package, both the creditors of the holding company and the uninsured depositors and creditors of the bank itself were benefitted. The actions of the banking supervisors in the

Continental case and in a number of subsequent cases involving large troubled institutions have been widely interpreted as the product of a Too Big To Fail policy.

It bears repeating, however, that there is no such explicit policy. Continental and subsequent cases need to be put in the context of the FDIC's longstanding preference for handling troubled bank situations in the most expeditious, least disruptive way possible. Furthermore, in those subsequent cases the FDIC has not only been much less willing to include holding company creditors and equity holders in rescue efforts that benefit the uninsured depositors and creditors of a subsidiary bank. It has also not automatically adopted a resolution method that fully protects all of the bank uninsured depositors and creditors themselves.

Of more general significance, however, is the fact that Too Big To Fail is much more than a problem of the deposit insurance system. Altering the present regulatory structure in an attempt to eliminate the perception of large banks being Too Big To Fail would merely shift responsibilities. The possible failure of a large financial organization presents macroeconomic issues that some arm of the government must consider. The evaluation of the economy-wide ramifications of the demise of a big bank is a government duty.

To put the matter another way, Too Big To Fail as an issue would exist even in the absence of an explicit deposit insurance program. And the result of protecting large institutions is to provide 100 percent insurance for the deposits in such institutions. Past experience in all major countries supports the contention that a Too Big To Fail policy exists, de facto if not de jure.

Therefore, the possibility that a failing large bank will be handled in a way that results in losses to uninsured depositors and creditors cannot be guaranteed. Many participants in the financial marketplace conclude based on past practices that large banks are safer than small banks. If changes in the deposit insurance system resulted in this view being more widely adopted, many marketplace participants might move funds to large banks regardless of any explicit policy requiring large bank depositors and creditors to suffer losses. The explicit policy would simply not be believed.

Thus the effectiveness of depositor discipline put in place by deposit insurance reforms designed to impose losses on uninsured depositors and creditors in all cases of bank failure is a difficult question. The stability of the system under such conditions must be evaluated.

INDUSTRY STRUCTURE

A healthy deposit insurance system depends ultimately on the existence of a healthy banking system. The discussion in Appendix I shows that the health of the banking system has been deteriorating. To halt this deterioration and give banks the opportunity to compete and remain viable in a fast-changing world should be the goals of efforts to reform the structure of the banking industry.

Structural reform of the banking industry primarily concerns three topics:

1. The Glass-Steagall Act;
2. The ownership and product limitations of the Bank Holding Company Act; and
3. Geographic barriers to bank expansion.

In 1987, the FDIC considered in detail the first two of these topics. The results were set forth in Mandate for Change: Restructuring the Banking Industry. The events of the interceding three years have not detracted from Mandate's conclusions that the Glass-Steagall Act and many of the restrictions of the Bank Holding Company may be not only unnecessary but also actually harmful to the banking industry. As is discussed in the Background section and Appendix I of this testimony, the financial environment has been changing to the detriment of the traditional banking business. The laws constraining the business have not changed, however.

Two of the conclusions reached in Mandate were that product limitations on bank holding companies and regulatory or supervisory authority by bank regulators over nonbanking affiliates of banks are not necessary to protect either the deposit insurance system or the payments system. Banking organizations should be free to offer a wide range of products and services, with the major caveat being that many of the products and services should be in uninsured subsidiaries or affiliates of a bank rather than in the bank itself. In addition, the FDIC in 1987 could discern no valid reason to limit the type of entities that can own or be affiliated with banks.

To carry the conclusions of Mandate a step further, there might be substantial benefits from eliminating the current ownership and activity restrictions. Risks could be diversified. Cross-marketing activities could enhance the profitability of the overall organization, although there would have to be restrictions on the use of insured funds to support uninsured activities. And the U.S. system for governing depository institutions could be brought into alignment with the systems of most of the other industrialized nations.

Regarding the last point, it is worth noting that the nations of the European Community, which is rapidly removing internal barriers to the movement of goods and services, have nothing that is comparable to the U.S. Bank Holding Company Act. Bank supervisory systems in Europe are aimed at the bank rather than at both the bank and any corporate owners.

In Mandate, the FDIC presented an order of precedence for the elimination of the excessive controls and regulation imposed by the Glass-Steagall Act and the Bank Holding Company Act. The first step would entail the enactment of the necessary legislation or the promulgation of the necessary regulations to ensure that the bank supervisors have adequate tools to police banks under the new regime.

Specifically, if the Glass-Steagall and Bank Holding Company Acts were substantially altered, the following controls should be part of the new supervisory system:

1. Restrictions relating to dividend payments and general loan limits should be uniform for all banks, whether chartered by the state or federal government;

2. The interaffiliate restrictions of Sections 23A and 23B of the Federal Reserve Act should cover transactions not only between banks and their affiliates but also between banks and their subsidiaries;

3. Equity investments in subsidiaries should be excluded from the determination of banks' required levels of capital;

4. Bank supervisors should have the authority to audit both sides of any transactions between a bank and its affiliates or subsidiaries and to require reports as needed from the affiliates and subsidiaries;

5. Bank supervisors should have broad explicit authority to determine which activities can be performed in the bank and which have to be conducted in affiliates or subsidiaries; and

6. The legal and financial separateness of the insured bank from subsidiaries and affiliates should be fully disclosed and criminally enforced.

Controls such as these are designed in large measure to insulate a bank from difficulties in affiliates and subsidiaries Can separateness be effectively established between the banking and nonbanking portions of a banking organization so that the bank's capital and the federal deposit insurance fund are not endangered by the nonbanking activities? The FDIC argued in Mandate that such separateness can be achieved. The suggested restrictions and limitations would merely be extensions of existing safeguards to protect banks from insider abuse, conflicts of interest, and the risks of certain types of endeavors. Where they have been adequately enforced by bank supervisors, such safeguards have worked well.

A case in point concerns the operation of life insurance programs by savings banks in Massachusetts. While the insurance programs and other programs within a bank have shared common names and quarters, there has been no commingling of assets or funds. The insurance programs have been separate and distinct from the other operations of the bank. No significant problems with the provision of life insurance by Massachusetts' savings banks have arisen.

The second step suggested in Mandate to bring about a new regime of bank supervision would be to eliminate the Glass-Steagall restrictions on banking organizations. A gradual phase-out of those restrictions would appear to be unduly cautious. For one thing, many securities activities would have to be conducted in subsidiaries or affiliates of banks, and these subsidiaries or affiliates would be subject to supervision and regulation by securities industry regulators.

For another thing, securities firms should be allowed to enter the banking business at the same time that banking organizations are given the right to conduct a full range of securities activities. Such an equitable removal of Glass-Steagall restrictions might be difficult under a gradual phase-out approach.

Some use of phasing, however, might be appropriate for Mandate's third step in a move away from excessive control over bank holding companies--the elimination of the ownership and activities restrictions of the Bank Holding Company Act. If these eliminations were legislated, affiliations with financial firms should probably be allowed to take place on a faster schedule than affiliations with nonfinancial businesses. Other than this broad guideline, the exact timetable would probably not be important. What would be important is that certainty be part of the process. There should be a specific sunset date when all limitations on affiliations would terminate.

The third topic regarding structural reform was not discussed in Mandate, but it is related to the bank holding company concept. To put the matter simply, the time may have come to allow unfettered nationwide banking. This means removing all restrictions on the establishment of bank branches across state lines. In this regard, the FDIC is pleased to note the initiative just taken by Senator Dodd in introducing a bill to bring about full interstate banking by 1994.

Interstate banking exploded in the 1980s, but the explosion was at the holding company level. Moreover, it came as the result of state rather than federal action. First in New England, then in the Southeast, and finally in all geographic regions, state legislatures moved to permit some form of interstate banking. The result is a bewildering variety of reciprocity laws, regional reciprocity laws, failing institution laws, and the like.

The states were responding to the imperatives of the marketplace. Halting the banking business at state boundaries was becoming more and more economically inefficient. In the Douglas Amendment to the Bank Holding Company Act, the states had a means to rectify matters. The Douglas Amendment permits the Federal Reserve Board to allow a bank holding company to acquire a bank outside its home state if the laws of the target bank's state authorize such an acquisition.

Unfortunately, the free market ideal of no geographic restraints on the banking business has still not been achieved. The mishmash of state laws imposes substantial restrictions on interstate expansion by bank holding companies. Just working one's way through the maze of state interstate banking laws requires a high-priced legal team. But more important, what is often the most economical way to expand geographically--by branching--is not readily available.

The 1927 McFadden Act severely restricts the ability of national banks and state banks that are members of the Federal

Reserve System to branch across state lines. There is no such federal constraint on state banks that are not members of the Federal Reserve System, but very few states have opened their borders to branches from out-of-state banks.

Interstate banking restrictions have contributed to the increase in risk in the nation's banking industry and to the decrease in banks' competitive capabilities. Banks have been hampered in attempting to lower risk through diversification. And banks have been constrained in expanding operations to match the expansion of banking markets that has been caused by technology and economic growth.

The nation's archaic geographic banking restrictions will become even more obvious and unpalatable in the near future as the European Community eliminates restrictions on branch banking. While European banks, and U.S. banking organizations with subsidiaries in Europe, make growth decisions based on market opportunities, banks operating in the United States will make growth decisions based to a large extent on what statutory loopholes can be found by the aforementioned teams of high-priced legal talent.

To summarize, the FDIC believes that deposit insurance reform should start with reform of banking industry structure. And structural reform should begin by identifying and examining the underlying obstacles to a competitive and viable banking industry. Topics that should be considered in this process are the Glass-Steagall Act, the product and ownership limitations of the Bank Holding Company Act, and interstate banking restrictions.

DEPOSIT INSURANCE REFORM

Given a viable and competitive banking industry, the deposit insurance system should be designed to ensure that the industry--both the institutions that provide products and services and their customers--bears the appropriate costs. The deposit insurance system should not result in a subsidy to the banking industry, particularly a subsidy that eliminates the penalties the marketplace imposes on reckless conduct.

It is easy to lose sight of the fact that any system of supervisory controls creates costs and benefits. Some sectors of the economy receive implicit subsidies, and other sectors pay implicit taxes. A complete tabulation of these costs and benefits is extremely difficult. The issue sometimes comes to the fore only when changes in the supervisory system are considered, or when a disaster such as the S&L crisis sheds light on the costs and benefits.

Regarding the S&L crisis, taxpayers were surprised, and not pleasantly, at the amount of the costs they had unknowingly accrued over the years.

One charge that has been made is that the banking industry has received a benefit from underpriced deposit insurance. The banking business has become riskier. The cost of deposit insurance, however, has not kept pace with the increased risk. As a result, the ratio of the bank insurance fund to insured deposits is at its lowest level in the FDIC's history (Figure 1). At year-end 1989, the fund, at $13.2 billion, amounted to 0.70 percent of insured deposits.

Increasing what banks pay for deposit insurance could be done directly, by increasing the insurance premiums, or assessments, that banks pay, as was done in FIRREA. The increase could be equally applicable to all banks, or it could be based on the level of risk in a bank's operations.

Imposing higher costs on banks for deposit insurance could also be done in a variety of indirect ways. One such way would be to increase required capital levels. Another way would be to reduce what is covered by the deposit insurance system, thus shrinking the amount of insured deposits, and perhaps the banking industry itself.

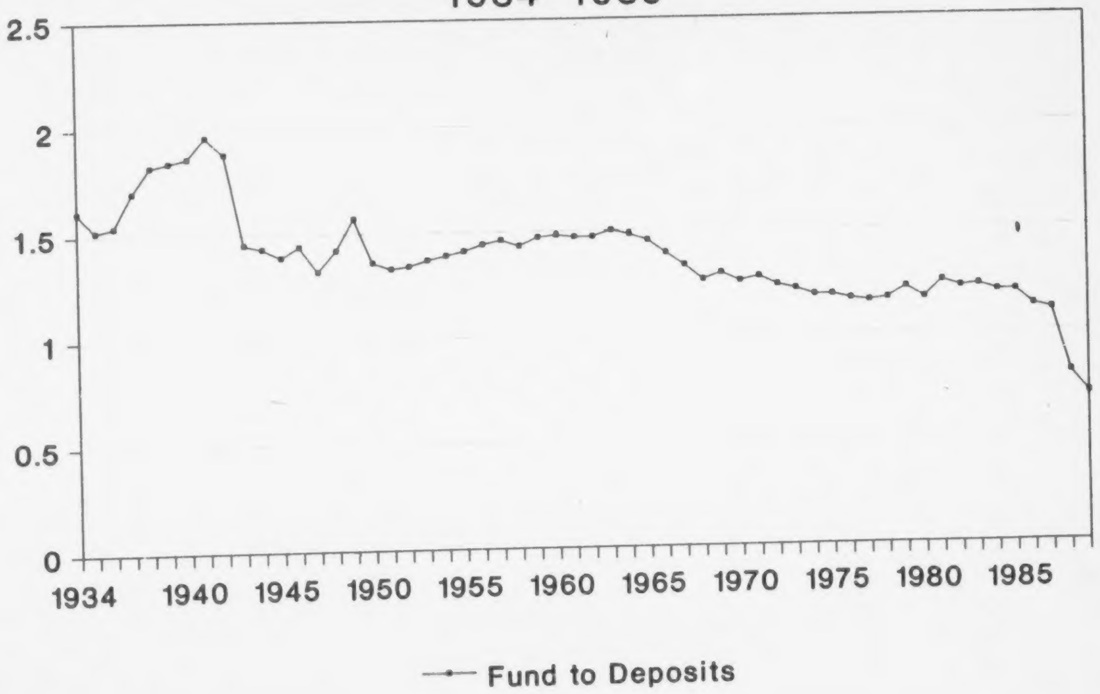
The mere mention of these possibilities highlights the fact that changes in the deposit insurance system, and the bank supervisory structure in general, entail shifts in costs and benefits. Such shifts are not painless.

In the remainder of this section, the topic of deposit insurance reform is examined under three headings. The headings are: liabilities, assets, and capital and structure.

Liabilities

Many proposals to reform the deposit insurance system concentrate on the liabilities side of the balance sheet. These

Figure 1: State of the Bank Deposit Insurance Fund
Ratio of Fund to Insured Deposits
1934-1989



Source: FDIC Annual Reports

proposals have the goal of limiting government's exposure by restricting or curtailing the amount of liabilities guaranteed.

Among the proposals--several of which are examined in greater detail in Appendices II and III--are the following: reduction in the statutory coverage limit from the current $100,000; limitation of coverage for each individual to a maximum of $100,000 per institution, across all institutions, or per lifetime; and limitation of coverage according to type of liability.

A particularly noteworthy proposal is the American Banker's Association coinsurance mandatory "haircut" proposal. Under this proposal, all uninsured depositors would suffer a loss in a bank failure. The loss would be based on the FDIC's average rate of recovery of assets in past failure resolutions. Since this average has been in the 85 to 95 percent range, uninsured depositors would suffer losses in the 5 to 15 percent range. The proposal envisions that even the largest banks could be successfully liquidated.

The FDIC is in favor of reducing its exposure to loss. However, limiting the cost of banking industry difficulties to the deposit insurance fund will entail tradeoffs, such as increased risk of instability in banking markets and the resulting possible adverse economic effects. This in turn could lead to reduced international competitiveness on the part of U.S. banks.

Such tradeoffs are likely to be more pronounced if a component of any alteration in the deposit insurance system is a reduction in the FDIC's options regarding failing institutions. That is, the less flexibility the FDIC is allowed in handling a troubled institution, the more likely it will be forced to select a more costly, more disruptive approach to resolving the situation.

Although one benefit of these types of proposals would be to increase the incentives for depositors to monitor more closely bank operations, it must be realized that there is currently a significant amount of market discipline in the banking system. The stock market, credit rating agencies, large depositors, all are sources of discipline. The fact that banking organizations in trouble do lose access to funding--Continental in 1984 and First Republic in 1988 are two examples--shows that considerable discipline already exists.

Moreover, deposit insurance reform proposals that are designed to increase depositor oversight of banks through the monitoring of deposits have their limitations. Only a small proportion of depositors have the resources and ability to make informed judgments about the condition of a bank. Even the best regulators, Wall Street types, and financial gurus have a very poor record of foreseeing banking problems much in advance.

Assets

Various proposals would approach deposit insurance reform from the asset side of the balance sheet. The idea behind these proposals is to limit what government insured deposits can be used to fund. The basic approach is to limit government risk by restricting the types of activities funded with insured deposits to those with the least risks. This approach has both promise and problems, as do all of the proposed changes.

One subset of these proposals focuses on a "narrow bank" concept. A "narrow bank" would be limited to investing in high quality, mostly government, securities.

The difficulty with the "narrow bank" idea--and indeed with any proposal that would reduce the type of assets that banks are currently allowed to hold--is the unpredictable effect it would have on the major beneficial function of banks: the provision of credit and liquidity to the private sector, which results ultimately in economic growth. Limiting deposit insurance protection to deposits that are only invested in the highest quality securities could well result in less credit and liquidity being provided to the private sector, and less economic growth.

Another subset of asset-related proposals would expand what banking organizations can do but limit use of insured deposits to a small part of the total operations. If the banking industry were given increased powers--primarily through relaxations in the restrictions of the Glass-Steagall and Bank Holding Company Acts--a major issue is where the new powers would be exercised: in banks themselves, in bank subsidiaries, or in bank affiliates.

This is a question for which there is no readily apparent precise answer. As a general guideline, traditional credit-granting functions could continue to be funded with insured deposits. Other financial activities could be performed in subsidiaries. And the most risky financial activities, along with nonfinancial activities, could be confined to bank affiliates.

Bank size could be a factor in the determination of whether activities would be conducted in the bank or in subsidiaries or affiliates. Small banks would most likely have less desire to engage in nonbanking activities. The costs of setting up subsidiaries or affiliates would not vary much by bank size, thus making it relatively more expensive for small banks to establish separate nonbanking entities. Difficulties in a single small bank pose less danger to the banking system than do difficulties in a single large bank. And small banks are easier to supervise. Therefore, a requirement to conduct some types of activities in subsidiaries or affiliates could be limited to banks above a certain size, say $100 million in assets.

Regulatory discretion would be necessary to implement a banking system freed from the restraints of the Glass-Steagall and Bank Holding Company Acts. For example, the development of the appropriate degree of separateness among banks, their subsidiaries, and their affiliates to achieve a balance between prohibiting improper use of insured funds and permitting economic synergies would require the capability of making a number of incremental decisions.

Capital and Structure

While the level of risk in the banking system has increased since the 1940s, the proportionate amount of capital has remained static (see Appendix I). In addition, failures in the banking industry increased dramatically in the 1980s, and the ratio of the deposit insurance fund to insured deposits is at the lowest level in the FDIC's history (Figure 1). Thus it seems appropriate that serious consideration should be given to phasing in higher capital requirements for banks.

Capital serves to protect both individual banks and the deposit insurance system. An adequate commitment of capital on the part of the owners of a bank can curtail the temptation to take excessive risks with the bank's funds. Curtailment of risky activity at individual banks would result in a more stable banking system and a healthier deposit insurance fund.

In addition, capital encourages more efficient and equitable pricing for the banking industry's products and services. One of the undesirable effects of deposit insurance is to enable banks to offer some products and services at prices below those that would prevail in an uninsured banking industry. Capital can serve to mitigate this subsidization effect. All other things being equal, more capital would require a bank to earn more revenue in order to maintain its return on equity. The requirement for more revenue would reduce the bank's ability to underprice.

Phasing in higher capital requirements would not be a painless process, however. Moreover, a general increase in capital requirements should probably not take place in isolation. Any such increase should depend on banking industry structural reforms, such as the alterations that were discussed earlier concerning the restraints of the Glass-Steagall and Bank Holding Company Acts. Then, as capital requirements for banks were raised, banking organizations would have various options regarding the movement of activities to uninsured affiliates or subsidiaries. The banking regulators would mandate the capitalization of banks, but the marketplace would determine the capitalization of the overall company.

Some proposals would alter the structure of the deposit insurance system by either eliminating deposit insurance or placing some exposure on private-sector insurance companies. The private insurance alternatives range from a totally private system with little, if any, governmental presence to partially private systems where the private and public sectors coordinate and share the insurance function. The basic premise is that the integration of private insurers into the deposit insurance system would lead to greater efficiencies in terms of pricing, risk monitoring, and closure of insolvent institutions.

The three main private insurance proposals are: private cross-guarantees of deposits; private insurance guarantees for deposits in excess of the statutory $100,000 limit; and reinsurance. Under the cross-guarantee proposal, deposit insurance would be mandated by the government but capitalized and operated by the private sector. Banks would be required to purchase deposit guarantees from insurance syndicates comprised of other banks. Additionally, banks could act as insurers by investing their capital in one or more of the syndicates. The government, at least implicitly, would be the backup insurer.

Under the excess insurance proposal, private insurers would offer voluntary insurance for deposits in excess of the statutory $100,000 limit. Prices for the excess coverage would become, in theory, market-based, thus capturing the efficiencies of a competitive market. In the reinsurance scheme, the FDIC would, as primary insurer, sell to private insurers part of the risk it has underwritten in the form of deposit guarantees.

These proposals have some degree of merit. Each of the proposals, however, entails pricing and administrative difficulties. Moreover, in the final analysis each fails in the ability to cope with systemic risk. If the banking industry encounters deep troubles, it is unlikely that a private insurance system could handle the situation. The government would remain the ultimate risk-bearer.

Additionally, private insurance most likely would not reduce the Government's supervisory responsibilities and the moral hazard problem. Any lessening of the need for the Government to supervise banks could be offset by the need to supervise the insurer or insurers. Indeed, it is unlikely that any private insurance system would impose more effective supervisory restraints on imprudent conduct by banks than does the present system. Detailed supervision is largely what controls improper activity and the moral hazard problem now, and detailed supervision is what would be necessary under any replacement system.

There are other useful ideas that could help the deposit insurance system. One type of proposal would convert deposit insurance to a risk-based system. Deposit insurance assessments would be determined by certain indicators of risk in a bank. The FDIC has been examining this topic for some time, and is required by a provision of FIRREA to report its conclusions to Congress by the end of the year.

Market-value accounting is also a concept that could have useful application in bank supervision. The market values of some types of assets, such as securities, can be ascertained without too much difficulty. Requiring such assets to be carried at their market values could result in more realistic financial statements for banking organizations.

REGULATORY STRUCTURE

Regulatory structure reforms should not be the tail that wags the dog. The issue of regulatory structure should be addressed only after the problems of structural reform of the industry and changes in the deposit insurance system are considered. How the regulatory structure should be altered will depend on how the problems of industry structure and deposit insurance reform are handled.

To put the matter another way, issues of regulatory responsibility and supervisory authority should not be allowed to obscure the more important need to rejuvenate banking industry competitiveness and viability. Nor should issues of regulatory reform be the predominant factors regarding changes in the deposit insurance system.

Once reforms concerning banking industry structure and the deposit insurance system are agreed upon, the difficult task of improving the rationality and efficiency of the regulatory structure can be tackled. That structure currently consists of three federal bank regulators, one federal thrift regulator, one federal credit union regulator, and a variety of regulators in the 50 states. Responsibilities are often overlapping and redundant. The concept of functional regulation takes second place to the concept of institutional regulation. The elimination of many of the outdated aspects of this structure would appear to be possible.

As a general guideline, experience indicates that the independence of financial regulators and insurers is essential to accomplishing the task of supervising the financial system without bowing either to the current political fad or to potentially large economic pressures. Further, banking supervisors should not be put in a conflict of interest by also being responsible for other important functions and objectives, such as monetary policy, international economic stability, and revenue production.

Supervision can be more uniform than it is today. More uniformity, however, would make it even more important that supervision be kept independent of other public concerns and political pressures.

CONCLUSION

The banking system has been undergoing significant changes. One way to characterize the changes is to say that the banking industry's monopoly on financial information has been eroding. Other players in the financial arena have been gaining ever greater access to financial information and consequently are relying less upon banks and the intermediary function they perform. Where these changes are leading is certainly one of the more intriguing economic questions of the Twentieth Century's last decade.

To enable banks to function in the changing environment, a number of alterations in the industry's structure appear to be needed. The major topics for examination are the Glass-Steagall Act, the Bank Holding Company Act, and the McFadden Act. When the appropriate changes are made, banks should be better able to adjust, under proper supervision, to the ongoing revolution in the financial marketplace.

Certain reforms in the deposit insurance system should probably accompany any changes in the legal underpinnings of the banking industry's structure. A number of such reforms have been suggested, many of them mentioned in this testimony. In the months ahead, the FDIC will be continuing its evaluation of these and other proposals.

The proposals cannot be looked at in isolation, however. A piecemeal approach to financial industry reform will not succeed. An overview is needed, an overview that recognizes the many interrelationships among industry structure, the deposit insurance system, and regulatory responsibilities.

APPENDIX I - A CHANGING INDUSTRY

Reform of the deposit insurance system must take into account not only what is happening in the world of depository institutions but also what changes are underway in the financial industry as a whole. Attempts to improve deposit insurance will come to naught if they are offset by conditions and trends elsewhere in the financial marketplace.

In an accompanying series of tables and graphs, three significant interrelated trends are isolated: banking is a riskier, more volatile business; banks are encountering greater degrees of competition; and the banking business is changing.

Banking Is Riskier

Perhaps the most persuasive piece of evidence that banking is a riskier business is the number of failed banks (Figure 1). Between 1943 and 1981, the greatest number of banks that failed in any one year was 17, in 1976. Annual failures increased dramatically in the 1980s, however, reaching a peak of 206 in 1989.

Net loan chargeoffs also rose significantly in the 1980s, reaching a peak of 1.15 percent of total loans in 1989 (Figure 2). A decade by decade comparison of the banking industry's return on assets reveal a fall in that measure of profitability during the most recent decade (Table 1). The slide is more evident when a trend line is fitted to industry return on assets for the period 1960-1989 (Figure 3).

One cause of bank difficulties has been a general rise in both the level and volatility of interest rates (Figure 4). Double-digit interest rates became common in the 1980s.

The marketplace has reacted to the banking industry's difficulties by being wary of bank stocks. As a percent of the Standard and Poor's 500 Stock Index, the Salomon Brothers 35 Bank Index has generally fallen since 1975 (Figure 5). The Bank Index was 55 percent of the S&P 500 in 1975, but only 38 percent in 1989.

Banks Are Encountering More Competition

The financial marketplace has become more crowded. A greater variety of players are offering a wider variety of products and services. One result is that the banking industry's share of financial sector assets fell from 34 percent in 1960 to 27 percent in 1987 (Table 2). The decline was most pronounced in the 1980s--banks still had 33 percent of the total in 1980.

The decline in the proportion of financial sector assets held by the banking industry was due to increasing proportions held by government-sponsored mortgage agencies, pension and retirement funds, and mutual and money market funds.

Figures 6 and 7 present more vivid evidence of the increased competition being encountered by U.S. banks. The commercial paper market has attracted a number of quality organizational customers that once relied on bank loans for short-term funds. The ratio of bank commercial and industrial loans to commercial paper outstanding has accordingly decreased (Figure 6). C&I loans fell from almost 10 times the amount of commercial paper outstanding in 1960 to only 1.2 times in 1989.

In Figure 7, the growth in competition afforded by foreign banking organizations is depicted. In 1972, foreign banking organizations controlled 3.6 percent of U.S. domestic banking assets. In 1989, the proportion was 21.4 percent.

A major change in the financial industry has been the growth of what might be termed nontraditional financial instruments. One example is provided by the packaging of mortgages for resale or to back the issuance of various types of securities. The proportion of mortgages in mortgage pools grew from one percent in 1970 to 23 percent in 1987 (Figure 8).

As another example of the growth of nontraditional financial instruments, the volume of financial futures contracts traded each year increased from 0.6 million in 1977 to 117 million in 1988, for an annual growth rate of 61 percent (Figure 9).

The Banking Business Is Changing

Defining with precision just what it is that banks do has provided economists, lawyers, and other interested parties with many hours of enjoyment but has not resulted in a great deal of success. One general function that banks can be said to perform is to provide credit. This only raises further questions, however, such as in what form and to whom.

The making of loans is probably the form that most often comes to mind when the credit-providing function of banks is mentioned. Loans, however, have not constituted a stable percentage of the banking industry's assets (Table 1). During the 1930s, loans were only 30 percent of industry assets. The percentage actually fell during the 1940s. The decline was due to the large quantities of government securities that banks acquired during World War II and to the constraints on non-war related economic activity during those years.

Since the 1940s, the proportion of loans in bank portfolios has steadily increased, reaching a peak of almost 60 percent for the period 1985-1989. While the loans to assets ratio of the banking industry was increasing, however, the equity to assets ratio remained static (Table 1). This has most likely resulted in a steadily increasing level of risk in the banking system because loans are for the most part more risky than the other major category of bank assets--investment securities.

As the percentage of the banking industry's assets devoted to loans has risen, the composition of the loan portfolio has changed. Two major changes are that the proportion of real estate loans has increased and the proportion of commercial and industrial loans has decreased (Figure 10). Real estate lending appears to be a more risky endeavor than C&I lending, so this change in loan composition has also likely increased the degree of risk in the banking system.

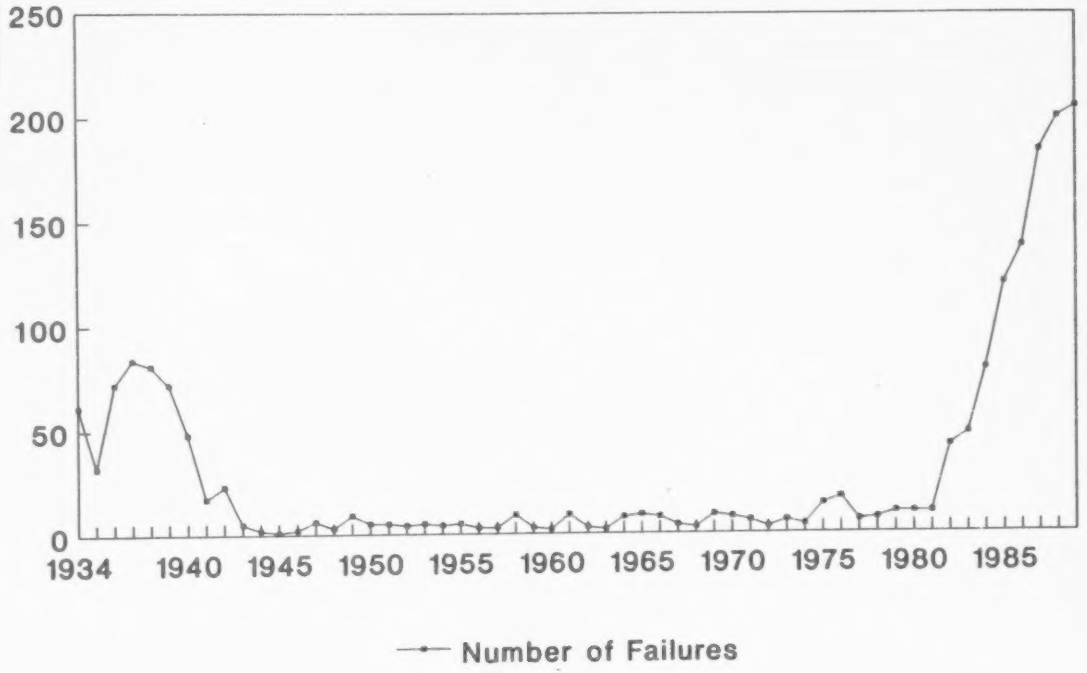
It bears emphasizing that the reduction in C&I lending by banks has not been a unilateral move. The rise of the commercial paper market has forced banks to seek other lending opportunities.

Other changes in the banking business bear noting. For one thing, noninterest income has become more important, constituting 16 percent of total income in 1989 (Figure 11). And off-balance sheet activities have increased substantially. The major categories of such activities grew in dollar terms from 58 percent of bank assets in 1982 to 116 percent of bank assets in 1989 (Figure 12).

Conclusion

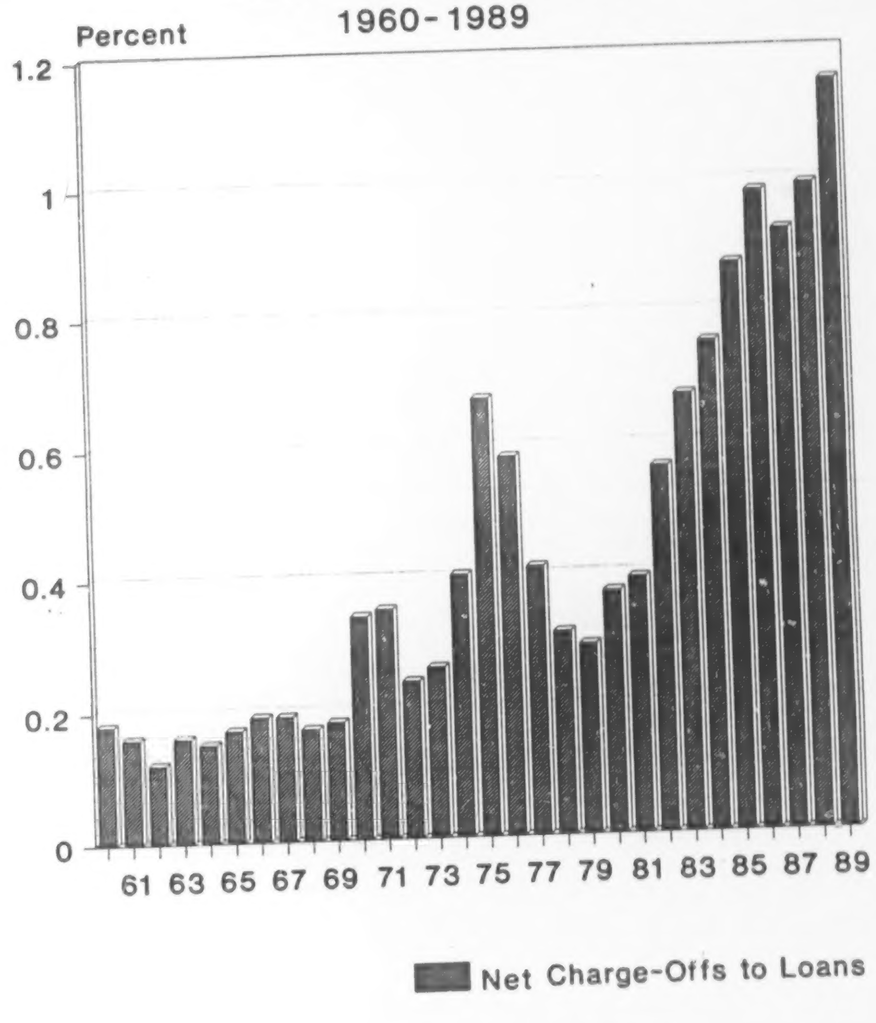
Thus the banking industry, and the financial marketplace in general, are undergoing significant changes. Volatility and risk seem to be on the increase, and there is no single simple way to contain the hazards. Moreover, legislative and regulatory efforts that do not recognize the changes taking place are likely to be ineffective.

Figure 1: Number of Failed Banks by Year
1934-1989



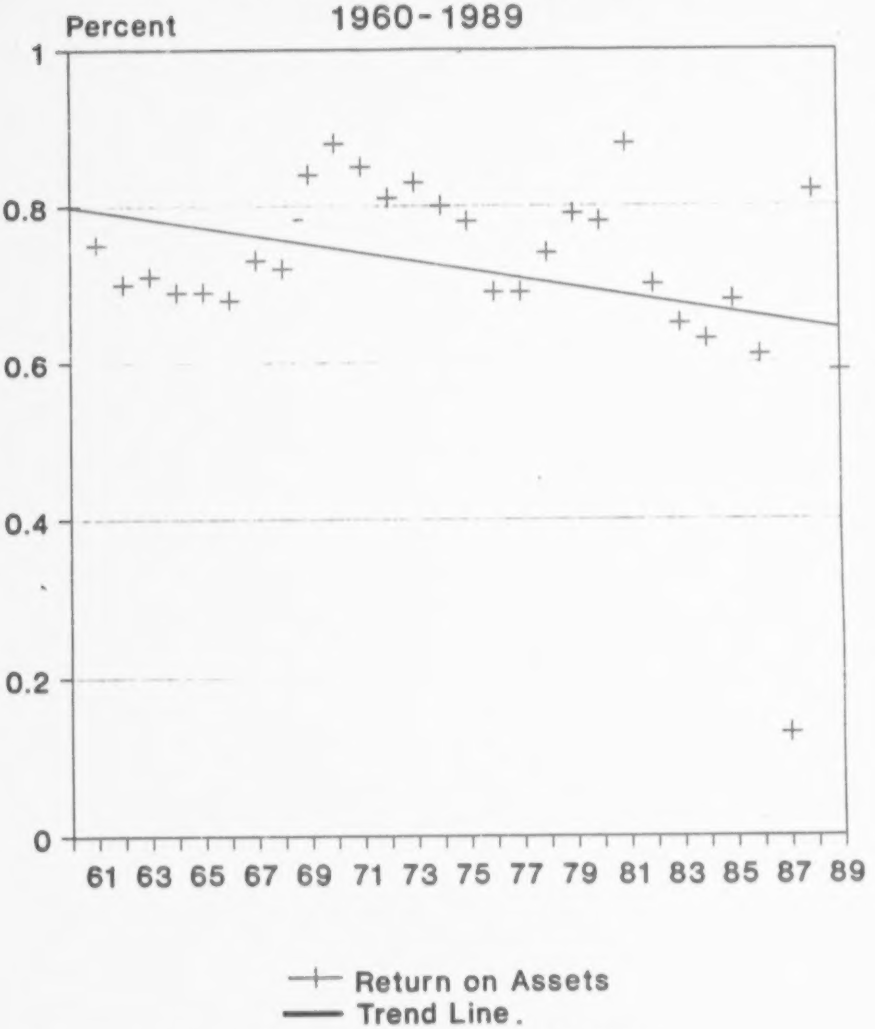
Source: FDIC Annual Reports and Statistics on Banking

Figure 2: Net Charge-Offs to Total Loans
Insured Commercial Banks
1960-1989



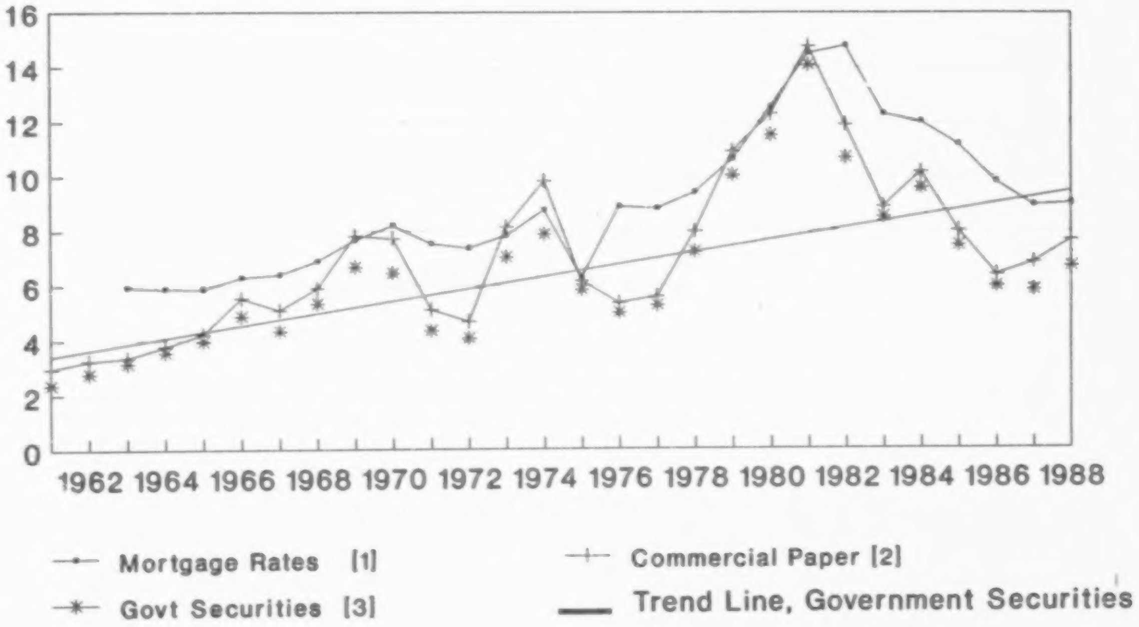
Source: FDIC Annual Reports and Statistics on Banking

Figure 3: Return On Assets
Insured Commercial Banks
1960-1989



Source: FDIC Annual Reports and Statistics on Banking

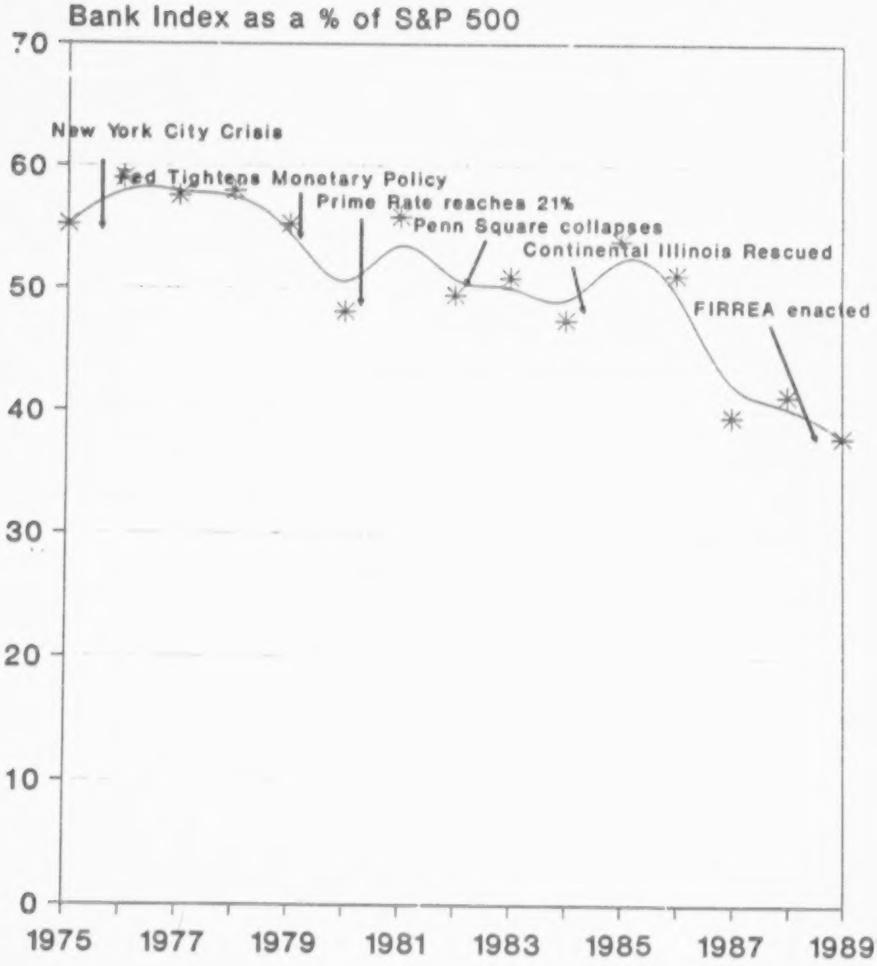
Figure 4: Average Interest Rates
1961-1988



Source: US Department of Commerce, Business Statistics

[1] Existing Home Purchases - U.S. Average
[2] Average Yield on 6-Month Maturity Paper
[3] Yield on new issue 90-day t-bills

Figure 5: Bank Stocks as a % of S&P 500
1975-1989



Source: Salomon Brothers

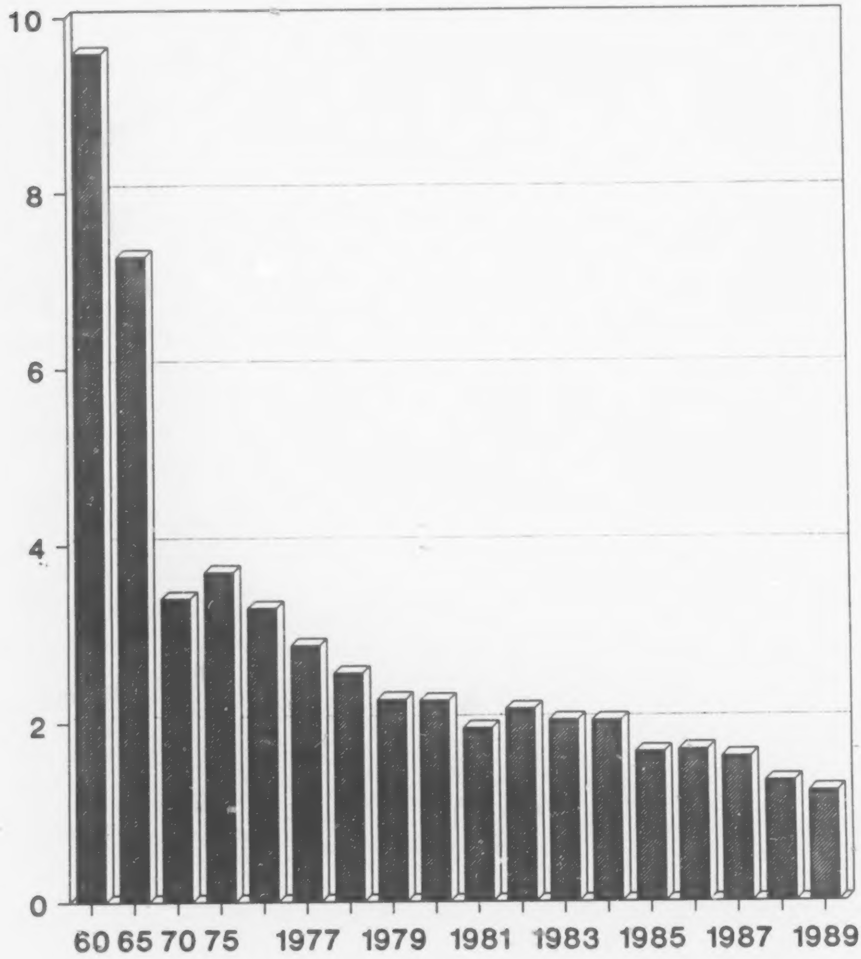
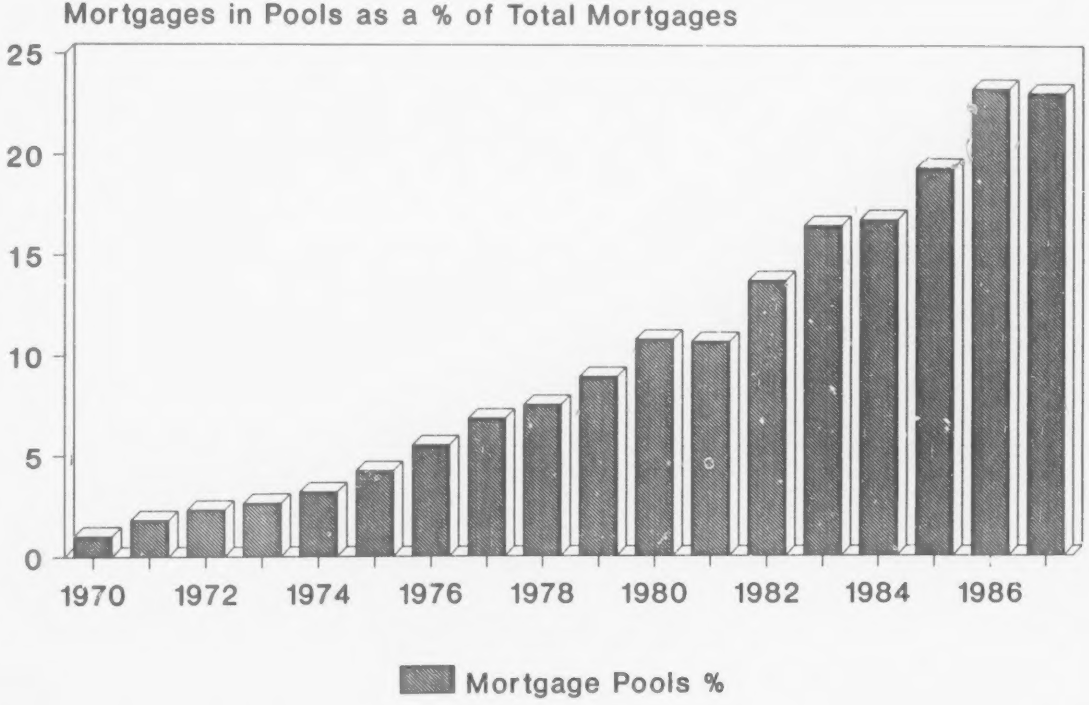


Figure 6: The Growth of the Commercial Paper Market
Ratio of Bank C&I Loans to Commercial Paper Outstanding
1960-1989

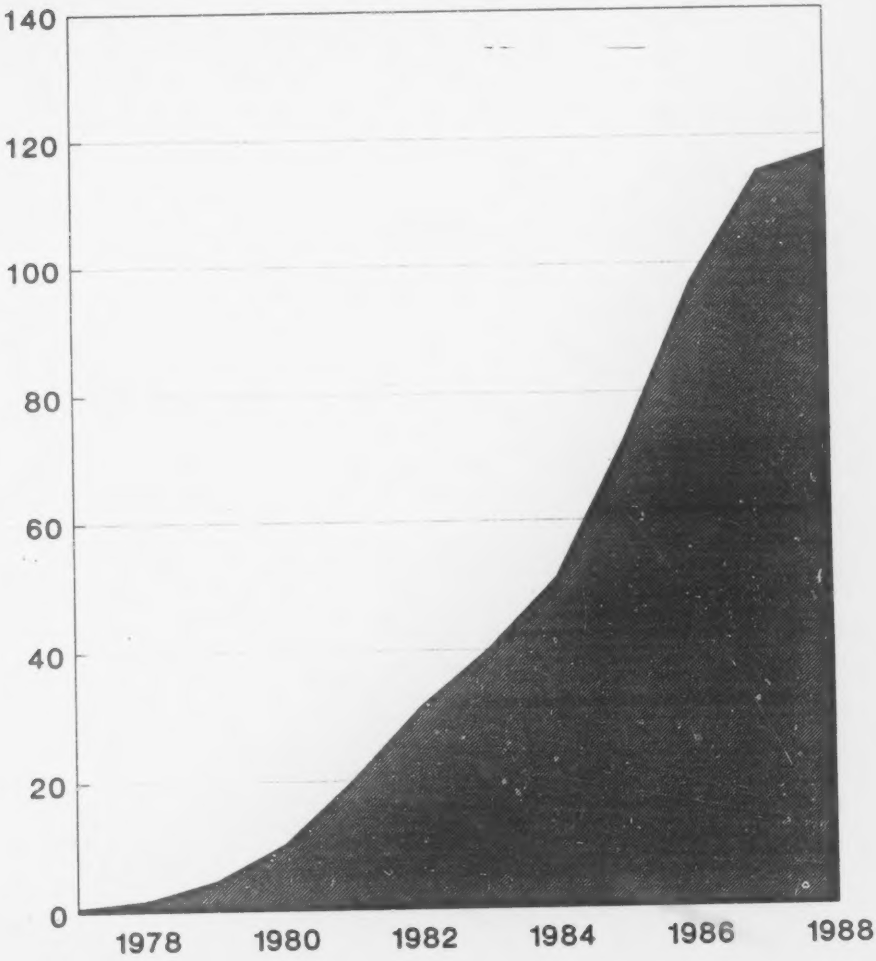
Source: US Department of Commerce, Business Statistics

Figure 8: The Growth of Mortgage Pools
1970-1987



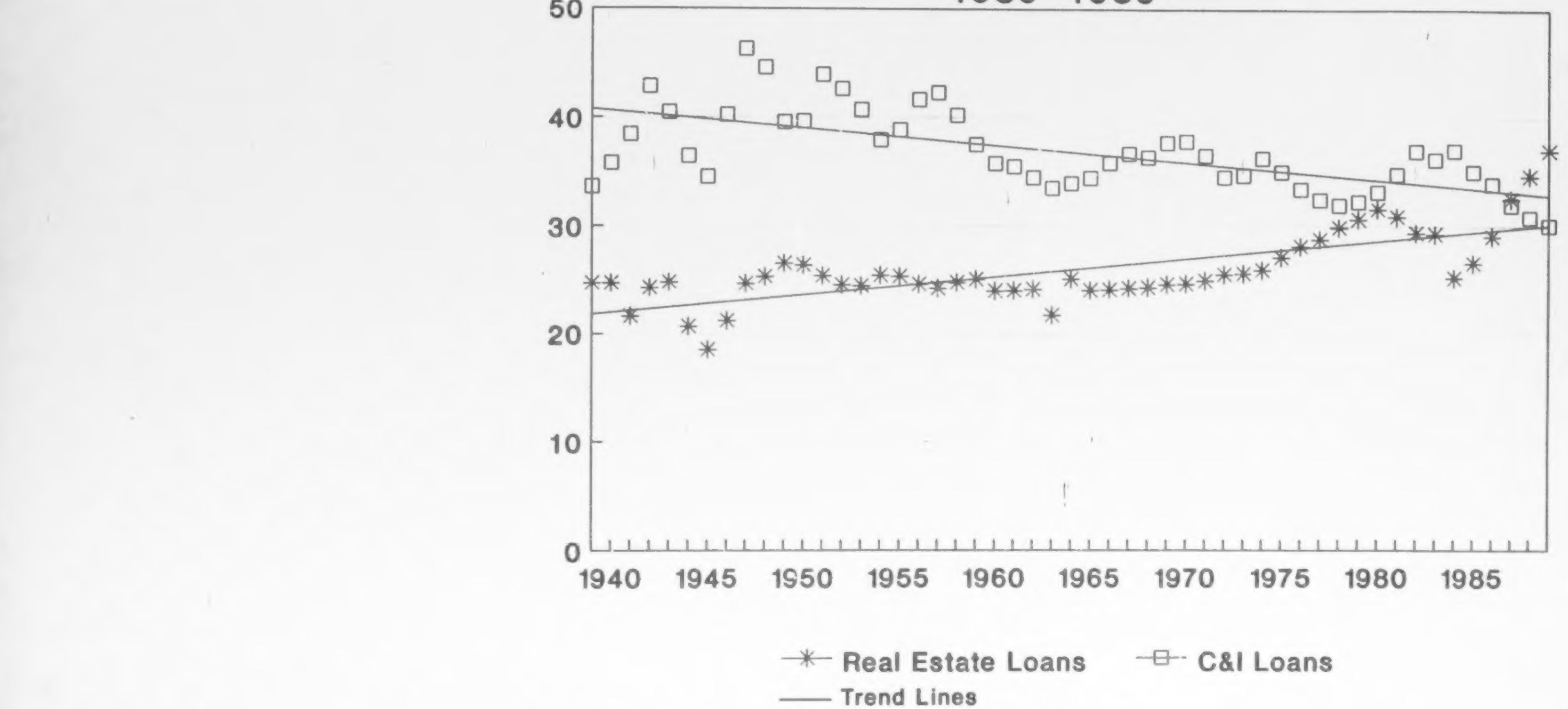
Source: US Department of Commerce, Statistical Abstract of the United States

Figure 9: Growth of the Financial Futures Market
Volume, in millions, of Financial Futures Contracts Traded
1977-1988



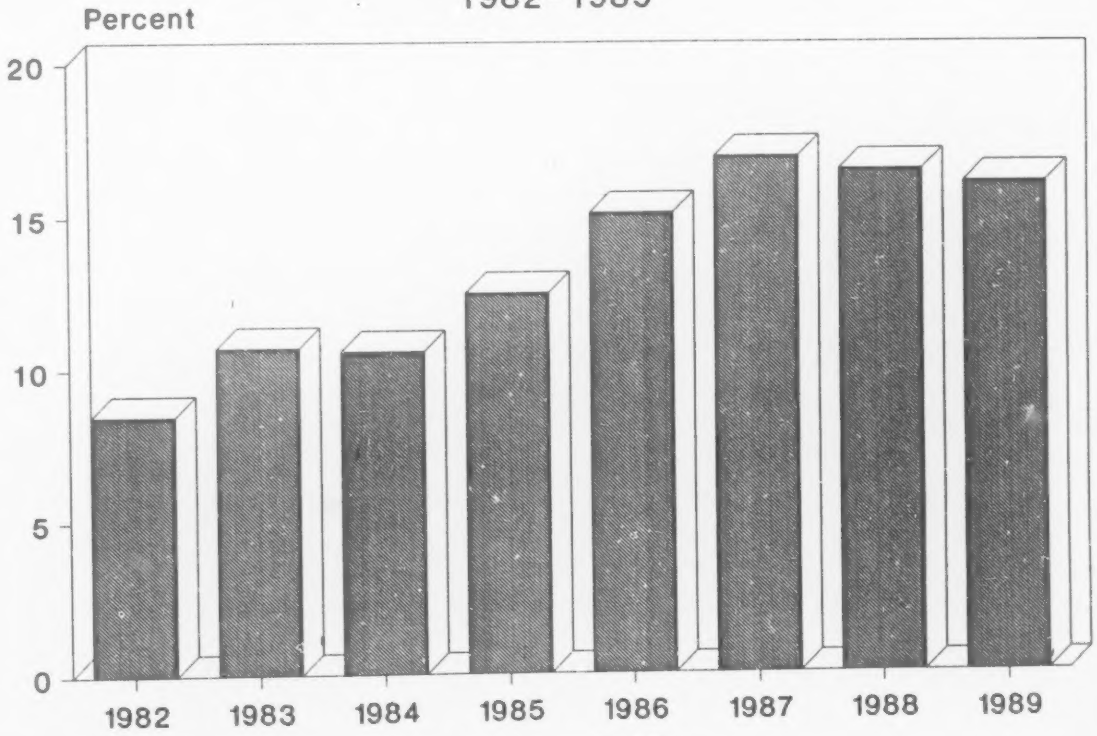
Source: Commodity Futures Trading Commission Annual Report

Figure 10: Real Estate and C&I Loans as a % of Total Loans
Insured Commercial Banks
1939-1989



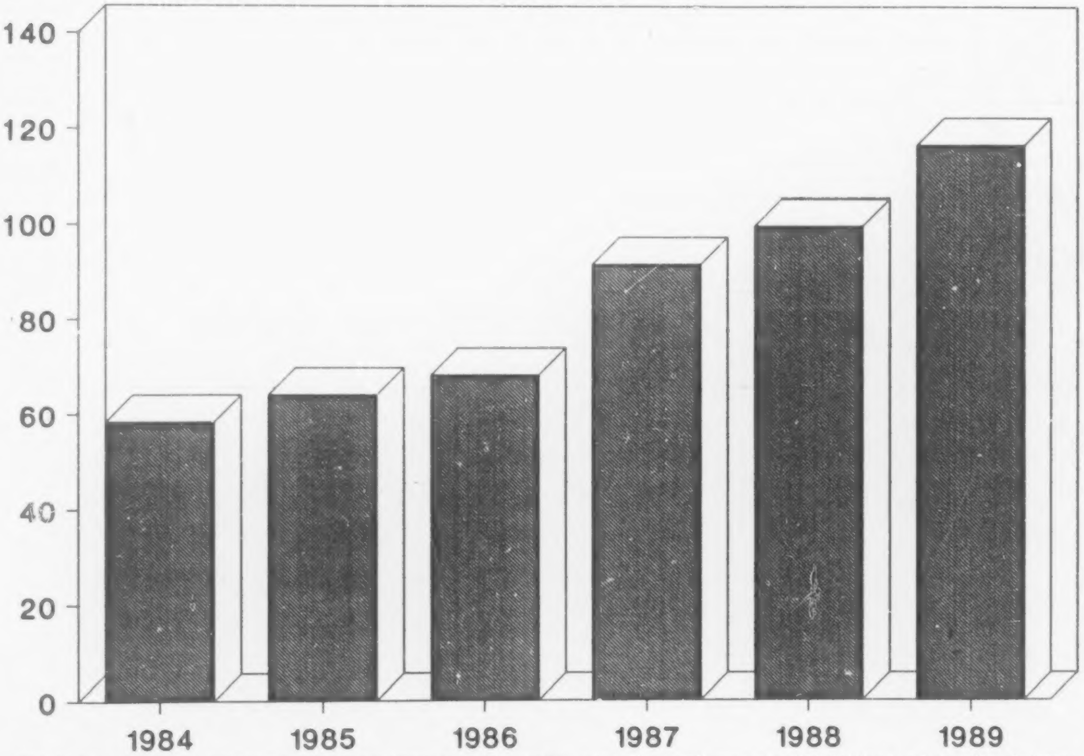
Source: FDIC Annual Reports and Statistics on Banking

Figure 11: Non-Interest Income as a % of Interest Income
Insured Commercial Banks
1982 - 1989



Source: FDIC Annual Reports and Statistics on Banking

Figure 12: Selected Bank Off-Balance Sheet Activities
as a Percentage of On-Balance Sheet Activities
1984-1989



Note: Off-balance sheet activities include loan comittments, standby and commercial letters of credit, futures and forwards contracts, and commitments to purchase foreign exchange

Source: FDIC Annual Reports and Statistics on Banking

TABLE 1: SELECTED BALANCE SHEET RATIOS INSURED COMMERCIAL BANKS

ITEMS	1930's	1940's	1950's	1960's	1970's	1980's	'80-84	'85-89
EQUITY/ASSETS	11.88%	6.89%	7.38%	7.62%	6.39%	6.11%	5.96%	6.22%
LOANS/ASSETS	29.43%	22.04%	38.35%	51.49%	53.73%	57.75%	54.71%	59.94%
LOANS/EQUITY (X)	2.48	3.20	5.20	6.75	8.41	9.45	9.18	9.64
RESERVES/LOANS	-	-	1.65%	1.98%	1.33%	1.78%	1.14%	2.20%
LOANS/DEPOSITS	33.92%	23.79%	42.19%	58.92%	65.00%	74.15%	69.67%	77.42%
RETURN ON ASSETS	0.46%	0.56%	0.61%	0.73%	0.77%	0.61%	0.69%	0.55%
RETURN ON EQUITY	3.84%	8.19%	8.22%	9.61%	12.09%	9.94%	11.65%	8.77%
NET INTEREST MARGIN	1.85%	1.46%	2.32%	2.76%	3.00%	3.32%	3.20%	3.41%
NET LOAN CHARGE-OFFS/LOANS AND LEASES	-	-	0.07%	0.17%	0.39%	0.82%	0.57%	0.99%
NET LOAN CHARGE-OFFS/NET INCOME	-	-	4.39%	11.88%	26.86%	78.39%	45.04%	108.96%

Source: FDIC Annual Report and Statistics on Banking

Table 2: Financial Assets held by Financial Sector
1960-1987

	Commercial Banks	Other Depository Institutions	Sponsored Agencies & Mortgage Pools	Monetary Authority	Insurance Companies	Pension and Retirement Funds	Mutual and Money Market Funds	Other
1987	27.24%	16.98%	10.40%	2.84%	13.78%	14.85%	7.64%	6.27%
1986	28.51%	17.28%	9.67%	3.04%	13.37%	14.69%	7.91%	5.52%
1985	29.49%	18.09%	8.80%	3.08%	13.66%	15.06%	6.21%	5.61%
1984	30.25%	18.98%	8.54%	3.17%	13.56%	14.75%	5.41%	5.34%
1983	30.32%	18.37%	8.21%	3.33%	14.03%	15.70%	4.79%	5.26%
1982	31.14%	17.67%	7.94%	3.56%	14.11%	14.86%	5.43%	5.29%
1981	32.32%	18.22%	7.28%	3.66%	13.95%	14.13%	4.95%	5.48%
1980	32.83%	19.11%	6.85%	3.85%	14.15%	14.74%	3.06%	5.41%
1979	32.80%	20.71%	6.68%	4.29%	14.81%	12.57%	2.50%	5.65%
1978	33.53%	21.64%	5.96%	4.57%	14.98%	12.03%	1.66%	5.62%
1977	33.49%	21.98%	5.41%	4.78%	15.13%	11.94%	1.65%	5.63%
1976	34.25%	21.56%	5.24%	5.09%	15.32%	11.06%	1.90%	5.59%
1975	35.30%	20.99%	5.14%	5.27%	15.10%	10.65%	1.98%	5.57%
1974	37.19%	20.26%	5.08%	5.27%	15.01%	9.46%	1.75%	5.98%
1973	36.96%	19.77%	3.87%	5.19%	15.37%	10.52%	2.30%	6.02%
1972	34.91%	19.51%	3.04%	5.17%	16.04%	12.21%	3.20%	5.92%
1971	34.89%	17.90%	3.02%	5.68%	16.44%	11.85%	3.39%	4.41%
1970	35.12%	17.29%	3.19%	5.76%	17.02%	11.46%	3.25%	4.54%
1969	34.81%	17.37%	2.65%	5.89%	17.44%	11.33%	3.53%	4.64%
1968	34.40%	17.52%	2.11%	5.93%	18.07%	11.29%	4.12%	3.90%
1967	33.94%	17.96%	2.03%	6.17%	18.72%	10.97%	3.83%	3.81%
1966	33.66%	18.40%	2.25%	6.35%	19.05%	10.47%	3.28%	4.12%
1965	33.53%	18.65%	1.85%	6.27%	19.26%	10.50%	3.50%	4.07%
1960	34.22%	16.97%	1.71%	7.90%	21.82%	8.75%	2.57%	3.65%

Source: Federal Reserve Board Annual Statistical Digest

APPENDIX II - ANALYSIS OF AMERICAN BANKERS ASSOCIATION DEPOSIT INSURANCE REFORM PROPOSAL

The American Banker's Association has presented a deposit insurance reform proposal for consideration by Treasury. The FDIC welcomes constructive proposals from all sectors of the public. This paper is an effort to contribute to the serious consideration that the proposal deserves.

The paper begins with a summary of the ABA proposal. Section II enumerates the benefits of the proposal. For the most part, these benefits are well recognized and speak for themselves. Subsequent sections of this paper describe some of the FDIC's concerns regarding the proposal. That these concerns are described in greater detail should not be construed as casting judgement on the merits of the proposal. Rather, these concerns are expressed in an effort to advance the public policy discussion in the most constructive way.

Section III discusses the potential systemic aftershocks of a major bank failure in which losses are imposed on uninsured depositors. Emphasis is placed on three avenues through which the effects could spread beyond the initial institution: correspondent balances; the impact on similar or neighboring solvent institutions; and disruption of the payments system. A key element of the ABA proposal is to minimize these aftershocks by developing computer systems at large banks that would enable the FDIC to resolve a failure at such an institution overnight.

Section IV examines the demands on bank operations created by the requirement that the FDIC make an overnight determination of insured balances and impose losses on uninsured balances in time to reopen the bank the next morning. It will be very difficult for these complex procedures to take place in the limited time frame at large banks. Developing, implementing, maintaining and monitoring these systems may be very costly. The section closes with a discussion of the specific method that the ABA recommends be used to calculate the exposure of uninsured depositors of failed banks.

Section V closes the paper with a discussion of market discipline in the banking industry and possible effects of increased reliance on depositor discipline in moderating risk. The section ends with a summary of issues that need to be considered before implementing the ABA's proposal or other measures of deposit insurance reform.

I - Summary of ABA Proposal

The proposal changes FDIC failure resolution policy. A new procedure, called "Final Settlement Payment", would be mandated. The mechanics are as follows:

1. Failed institutions would be placed in receivership at the close of a business day. Overnight, a determination would be made of exactly which deposits are eligible for insurance. The key to enabling this to occur in a large bank failure is the proposed development computer programs and data bases at all large banks that would automate this process.

2. The following business day, a new entity assumes all insured deposits. This entity would either be an acquiring institution or a bridge bank.

3. The successor institution would also assume a fixed percentage of all uninsured deposits (approximately 85% - 95%). This percentage would be adjusted over time and is intended to reflect the FDIC's average rate of recovery of assets in past failure resolutions.

4. Uninsured depositors would not have any further claim on the assets of the receivership. Any gain or loss on the disposition of receivership assets would remain with the FDIC. For example, if the FDIC's experience was to collect 92% of all receivership assets, all uninsured depositors in the next failure would receive 92% of their funds immediately. If the FDIC subsequently recovered more than 92% of this specific bank's assets, it would keep the excess. Similarly, if the FDIC recovered less than 92% in the specific instance, it would absorb the added loss.

Other elements of the ABA proposal include:

* The elimination of deposit brokerage. (A pending ABA report will elaborate on this topic).

* The continued improvement in the strength of the bank examiner corps.

* The suggestion that additional attention be paid when granting new bank charters and supervising newly chartered banks.

* An appeal to bank regulators in other industrialized nations to develop depositor protection programs that incorporate market discipline and allow for depositors

in major institutions to suffer losses in the event of failure.

II- Benefits of ABA Proposal

The ABA proposal mandates that uninsured depositors face losses in bank failures. It also resolves many of the administrative hurdles that reduce the likelihood that losses will be imposed on uninsured depositors in major banks. The result could be the following public welfare gains:

- Increased levels of depositor discipline. This should act to encourage safe and sound banking practices and discourage excessive risk taking by bank managements.
- The elimination or reduction of the systemic risks that would occur in a major bank failure.
- The equalization of the treatment of depositors at large and small institutions.
- The minimization of costs to the insurance fund and to the banking industry which finances the fund.
- A greater reliance on market forces, as opposed to governmental intervention, to control bank risk.

III - Systemic Risks in Large Bank Closings

Caution needs to be exercised when considering policies concerning failure resolution of major banks. These cases have a greater potential of triggering larger economic disruptions or crises. At the same time, over protection of these institutions can distort the efficient allocation of resources in the economy. Areas of concern regarding systemic risk in major bank failures are discussed in this section. Three avenues are considered through which the destabilizing effects of a major bank failure can spread through the financial sector or the larger economy.

1. Impairment of correspondent banks.
2. The effects of market perception on neighboring or similar banks.
3. Disruption of the payments system.

1. Correspondent Banks

The ABA proposal will impose a haircut on all large depositors in the event of a bank failure. If other banks are among the newly shorn depositors, these banks may face losses which could: 1) create liquidity problems or; 2) exceed net worth.

Large banks tend to be net borrowers from smaller banks. These moneys may originate from correspondent banking activity (clearing checks, safekeeping of securities, etc.) or through Fed funds borrowings. Large banks also hold extensive balances with each other, often as a result of check clearing arrangements. Thus, a large bank failure could affect many other institutions.

The ABA suggests that one reason that the FDIC was reluctant to impose losses on depositors at Continental was because of the large number (976)[1] of banks that held deposits over $100,000. The ABA proposal, because it envisions the overnight adjustment of account balances and the normal functioning the next day of a successor institution, would not cause direct liquidity problems for the banks holding deposits at the failed institution. However, if the losses imposed on the banks is great enough to impair net worth, the correspondent banks could suffer from runs by uninsured depositors, or even insolvency.

The ABA argues that, because depositor losses would be a fraction of the total uninsured balances, the impact on the net worth of a correspondent bank would be minimal. In the case of Continental, if a 30% haircut had been imposed, 6 banks would have faced losses greater than their capital, and 22 other banks would have incurred losses greater than 50% of their capital. Had the haircut been only 10% (which is closer to expected the level that would be set under the ABA proposal), only 2 banks would have suffered losses greater than 50% of capital, neither of which would have exceeded capital.

One reason that small banks hold correspondent balances at large banks in their district is to clear checks (see Attachment A on the check clearing system to learn about options available to small institutions). By their nature, these activities involve large amounts of money. If an economic downturn adversely affected all major banks in a region, a small bank might be hard pressed to find a completely safe, major, local bank to use for these services[2]. For example, 9 of the 10 largest banks in Texas were closed or assisted during a 3 year period. It is easy to imagine a community bank moving its check processing business from one failing bank to another, taking several haircuts which, in total, cause insolvency.

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[1] The numbers cited in this paragraph, and the next, are from the ABA proposal.

Another conduit through which banks would be exposed to losses from another bank's failure is the Fed funds market. This market is primarily overnight loans from banks with excess reserve balances to banks with deficient reserves. The general pattern of Fed funds lending is for large, urban banks to be net borrowers on this market and for small, rural banks to be net lenders.

In their proposal, the ABA envisions this market acting as an adjunct to the Federal Reserve's role as lender of last resort. The ABA argues that banks are among the depositors who are best able to judge the viability of competing firms. If the public flees otherwise healthy banks, and moves funds into institutions that it believes are stronger, the recipients of these funds could rechannel this money to the threatened institutions via the Fed funds market. Thus, the ABA sees other banks providing both market discipline and market stability.

There is a concern, however, that these two roles may be mutually exclusive. Bank runs can become self-fulfilling. Even if a bank believes that, absent a run, another bank is financially sound, given that a run is taking place, it would be uncertain about the viability of the exposed bank. The exposed bank's survival will depend on the behavior of its remaining depositors and the willingness of other institutions and the central bank to lend to it. A bank lending Fed funds could not accurately measure these factors, and would not want to risk the possibility of an overnight loss. A system which imposes losses on bank creditors of failed institutions in order to increase market discipline, may not be compatible with the goal that banks provide stable funding during panics.

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[2] Small banks could utilize the local Fed for check clearing. However, it may not be wise policy to drive this business away from major banks in distressed regions. This activity can be profitable, and the risks are uncorrelated to those within a loan portfolio. Check clearing operations are driven by scale economies, so taking business away from a troubled bank would reduce revenues without an equivalent short term reduction in costs, further weakening the firm.

2. Effects on Similar / Neighboring Institutions

One other mechanism through which the effects of an individual bank failure could spread to other institutions would be from a change in the behavior of depositors at an otherwise healthy bank. Under the ABA plan, depositors with uninsured funds would have incentives to run. Therefore, if a particular bank failed due to credit problems in a distressed region or industry, depositors at banks in the same market might fear that their institution is also at risk and begin running.

The ABA plan assumes that there will be greater stability among worried depositors under their plan than if depositors were uncertain of the extent of their potential loss. It is not clear that the volatility of a deposit base is a function of the fractional loss that would be felt in a failure. A depositor who observes a potential failure/run would want to join in the run as long as the transaction cost of moving funds is less than the potential loss from staying in the bank. In other words, if depositors at bank A feared that they might lose 30% of their funds in a failure, and depositors at bank B feared that they would lose 10% of their funds in a similar situation, both banks would experience the same deposit drain if transaction costs are minimal (which they are for transaction and money market balances).

The ABA system would continue to protect banks from runs by small depositors. However, it would expose the industry to the possibility of runs on otherwise healthy institutions by uninsured depositors. In many large banks, runs of small depositors are not threatening. Continental Bank, for example, failed when large overseas depositors lost confidence.

This proposal might impair the ability of banks to provide services which involve large flows of funds. The reasons that correspondent banks might take check clearing activity away from a troubled bank are discussed above. Corporate users of check clearing services would have similar incentives to bypass the entire banking industry. Lockbox operations are an important non-credit source of revenue for banks (the risks of which are uncorrelated with the risks in a loan portfolio). A corporation using such a service directs its customer's payments to a post office box which is rented and controlled by the corporation's bank. The bank continuously collects the mail that has been delivered to the box, quickly deposits the funds into the corporation's account, and immediately enters the check payment into the collection system. Two criteria guide the choice of lockbox processor. One is optimal geographic location to minimize the time that payments from the corporation's customers are in the mail. The other important criteria is the ability of the bank to rapidly collect payment on the checks it processes. This ability is a function of the breadth of the correspondent network maintained by the bank. Therefore, large banks have an advantage in providing this service.

If a lockbox customer became concerned about the viability of the bank providing the service, it would not be able to quickly end its exposure to losses at that bank.[3] At present, because there may be a wide spread perception that regulatory policy will protect large depositors at the large bank providers of lockbox service, corporate customers may be minimally concerned about this potential exposure. However, if a large bank failure occurred in which lockbox customers experienced losses, corporations might be tempted to use providers of these services outside of the banking industry. Private lockbox servicers do not offer economic advantages over bank providers (in fact, because banks have monopoly access to the payments system, private firms could not match the funds availability offered by banks). This potential movement of business out of banks would be solely to avoid losses during an unexpected bank failure. Therefore, it would not be a form of discipline directed at a poorly run institution. Rather, it would be a flight from the entire industry.[4]

3. Payments System Integrity

Much of the ABA's proposal is concerned with maintaining the integrity of the payments system. The three major components of the system are CHIPS, Fedwire and check processing networks. The ABA makes recommendations concerning CHIPS that would reduce disruptions to that system. However, such reforms involve the possibility of CHIPS participants sharing a loss that would occur if a member failed while in an overdraft position. The risk of such losses is an unavoidable consequence of the operation of such a payment network. However, it emphasizes the vulnerability that the entire system has in the event of a major bank failure. CHIPS participants will have adjusted their exposure levels so that potential losses there are sustainable. However, if any of these participants have additional exposure to the failed bank from other inter-bank activity, its own viability may be threatened and its own depositors might start running. We must be cautious about establishing policies which might mandate additional losses on these institutions.

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[3] Many lockbox arrangements involve custom-made processing agreements. Negotiating these terms with new potential providers may take time. Once a new provider is selected, it may take 90 days or more for previously mailed invoices to be paid. During that time the firm is still exposed to the risk of failure of the old bank.

[4] The checks processed in a lockbox would still have to be deposited in a bank for clearing. However, the other services provided by bank lockbox departments, including direction of remittances to optimal post offices and the capture and reporting of accounts receivable data, could be provided by non-bank firms. The final step, entering the check into the payments system, could be quickly redirected if the clearing bank's viability was threatened.

Fedwire

An important element of the Fedwire system is payment finality - an institution receiving funds is guaranteed payment by its Federal Reserve bank, even if the institution that originated the transfer subsequently defaults on its obligation to its own Federal Reserve bank. Payment finality enables a bank to immediately credit the account of its customers receiving electronic payments. This permits the funds to be immediately used for other payments or investments and increases the efficient allocation of capital resources in the economy. Payment finality prevents a bank failure from affecting other banks that transacted business with it prior to failure. The risk is transferred to the Federal Reserve banks or, if the intra-day credit is fully collateralized, to the FDIC, uninsured depositors and unsecured creditors.

The Federal Reserve Board has developed policies during the past several years that are aimed at reducing its potential exposure to losses from Fedwire operation. Banks are restricted in the amount that they may overdraw their reserve accounts at any moment in time. These restrictions are tightened as the viability of an institution is threatened.

It may be difficult to balance the ABA's desire to wait until the close of business before declaring a bank insolvent with the Fed's requirements to protect itself from Fedwire risk. An interesting question is what should happen if the Fed refused Fedwire transactions from a failing institution which, facing a run, had exceeded its daylight overdraft limits. Depositors in the bank would be unable to withdraw their funds. What would be the legal standing of a customer who had requested a funds transfer before a bank was declared insolvent at the close of the business day, but whose funds were not wired due to the Fed's refusal to accept debit transactions from the failing bank? Would this depositor be subject to a haircut from the liquidator? Does such a potential event add to instability by increasing the likelihood that uninsured depositors will run quickly instead of waiting for events to develop?

Check Clearing

The rest of this section describes the disruptions that would be likely to occur to the check collection system if a major bank were closed for several days during a failure resolution. The ABA proposal resolves most of these problems by suggesting that failed banks be re-opened the next morning. Section III describes why it may be difficult to develop the necessary systems to accomplish this. Given the disruptions described below, it may be prudent to develop the necessary technology before establishing certain policies.

The check clearing system has a certain amount of resiliency built into it. Deposit-taking institutions provide their customers with provisional credit when receiving checks. If the check is later dishonored, and returned to the bank of first deposit, the customer's account is debited. Because of the large volume of dishonored checks, systems have been built to minimize potential losses to deposit taking institutions. The recent implementation of Regulation CC holds out hope for further improvement to this system.

Approximately 1% of checks written are dishonored by the drawee bank.[5] In order to return these checks, they are manually encoded with magnetic ink with the amount and the code for the bank of first deposit (Determined by searching the back of the check for a specific endorsement stamp). The encoding permits rapid movement through the clearing network back to the point of origin. Checks dishonored due to bank failure could be handled through these channels - even in the case of large banks - though not without imposing great strain. Essentially, the work load of the clerks performing this task would increase 100 fold. Deposit taking banks are entitled to timely notification by telephone or wire if items over $2,500 are to be dishonored. It would be difficult to make timely notification if all large items drawn on a major bank were to be returned since again, the workload of the clerks performing this function will have increased 100 fold.

Delays in processing these returned items could lead to losses to the banking sector. The bank of first deposit, absent timely notification or presentment of the dishonored check, will be providing its customers with access to the deposited funds within 2 to 5 days[6]. If notice of the return arrives late, the funds may have left the bank, and the customer be unavailable or unable to refund the money (the customer may have also released goods or payments under the assumption that the deposited check was honored). Under the Uniform Commercial Code, the bank of first deposit can protest to the drawee bank if the return was not initiated timely (within 36 hours), Ultimately, one of the two banks will have to absorb the loss[7].

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[5] Bank Administration Institute Survey of the Check Collection System Bank Publishing, Rolling Meadows, 1987 page 33.

[6] As mandated by Regulation CC.

In order to protect themselves from accepting checks drawn on large banks that are about to fail, many deposit taking banks, or their check clearing agents, could program their computer systems to refuse items drawn on such banks. At present, customer access to funds deposited by check is based on the geographical location of the check, and the transportation schedules to those parts of the country. If final settlement payment methods were mandated in all bank failures, and banks in the check collection chain were at greater risk due to late return of items drawn on failed banks, banks would wish to delay the availability of good funds to depositors based credit worthiness of drawee banks. This would mimic, in miniature scale, the discounting of bank notes that occurred during the Free Banking Era. However, because Regulation CC would prohibit such delayed availability, the bank of first deposit might refuse the check, and return it to the depositor for manual collection. In this manner, the efficiency of the check payments system could begin to deteriorate.

In the case of a major bank failure, the check processing system could be affected in other ways. Section I briefly discussed the difficulties, in a world of haircuts, faced by small institutions in need of check clearing services. Major disruptions would occur if a significant provider of these correspondent services was unable to accept deposits while closed for failure resolution. In some markets, there may not be sufficient outside capacity to handle the volumes processed by the major provider. Other local banks would suffer financial loss as it would take longer for them to convert check deposits into good funds. Any delay in entering their checks into the collection stream will also delay their learning which items were dishonored by the drawee bank.

Significant disruptions would occur in other sectors of the economy. Customers of failed banks might find that payments they had made (including those made before the bank failed but which were still in process) to suppliers and employees were being dishonored. This could cause hardship, especially if the checking account balances remained frozen and alternative sources of funds were unavailable. If a firm had a lockbox arrangement, as well as its checking accounts, at the failed bank, both existing funds and new receipts could be tied up or frozen. These disruptions would act to increase the social cost of a bank failure.

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[7] It would be possible to pass some of the processing burden on to the local Fed in its role of "Returning Bank" under Regulation CC. Unencoded (raw) items can be presented to the Fed, at an earlier deadline, for processing and entry into the automated stream. Regulation CC is unclear as to whether liability for delayed processing of raw returns exposes the Fed to potential losses if it is unable to process these items within standard time frames.

IV - Operational Considerations

The ABA proposal resolves much of the systemic risk posed by a major bank failure by assuming that conditions can be established which enable the FDIC to calculate the insurance level of each depositor, apply appropriate haircuts to the uninsured balances, and open a bridge bank the next morning. Under such a scenario, the following procedures would need to be performed:

1) Account balances are aggregated by some type of coding that links like ownership categories together.

2) Owners with aggregate balances over $100,000 are reported.

    a) Using complex decision rules[8], the computer assigns the full amount of the haircut to the depositors' excess balances. Or

    b) FDIC Liquidators pick and choose which balances to reduce.

3) Reductions are posted to the accounts. The transactions are balanced.

4) Reports are produced listing the reduced accounts.

5) Notices are generated to inform customers about their haircuts. These notices would have to identify all of their accounts.

Because the FDIC would be depending on the computer systems to perform these tasks flawlessly the first time that they are put into operation, exacting compliance verification procedures would be required. At minimum, full dress rehearsal tests would have to be conducted during bank exams in order to have any confidence that the systems would work if needed.

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[8] The decision rules become complex if they do anything other than apply the loss equally across a single depositor's accounts. Some writers suggest applying the haircut to accounts with long maturities first in order to minimize disruptions to the payments system. The depositor would object if his longest term account was locked into a favorable interest rate compared to contemporaneous rates.

Even if these programs were created, and were operational, it is uncertain that there would be time to execute them. It is easy to imagine that a bank shuts down when the Tellers go home. This is far from the truth. Major banks have operations going on 24 hours a day. In fact, most of the day's transactions are not posted to the customers' accounts until overnight processing begins. A typical bank operations schedule is described in Attachment B. The ABA envisions that the complex special programs complete their operation between the time that normal processing is completed and the start of the next business day. This may not be possible in the case of a large bank even if the closing were postponed until the weekend.

The ABA proposal also acknowledged that all current bank accounts would have to be re-coded to specify the ownership relations that determine insurability. Such labor intensive activity could be even more costly to banking firms than developing the new computer programs that the ABA plan would require.

It appears that the costs to the banking industry of implementing this proposal would be considerable. The FDIC is very sensitive about the imposition of costly regulatory burdens. Ultimately, a healthy industry will expose the insurance fund to less stress. However, the FDIC welcomes the development of such systems to the extent that they can be completed in a cost effective manner. These systems have the attractive feature of reducing the cost of the FDIC's option to pay off or transfer a failed bank's insured deposits. To the extent that administrative and technical problems can be addressed and resolved in advance of the crisis atmosphere of a major bank failure, the costs of a payoff will be reduced.

Final Settlement Payment

The FDIC has serious reservations about the ABA's proposed method of applying losses in bank failures. Because their plan requires that a failed institution be re-opened the next day, the ABA would not base the percentage loss on the expected recovery of the remaining assets. Estimating the recovery rate could take several days or weeks. Instead, the payment would be based on the rate of recovery on assets in past resolutions.

In a final settlement payment, as described in the ABA proposal, a single payment is immediately made to all uninsured depositors and unsecured creditors. A final settlement payment differs from past methods in that depositors and unsecured creditors at one bank may receive less than what they would have in a straight or modified payoff. The difference would be given to their counter-parts at failed banks in which recovery is worse than normal.

The legality of seizing property in excess of recovery costs from uninsured depositors and unsecured creditors in some failures is questionable. Although the ABA does not anticipate that the FDIC would make a profit across resolutions, it anticipates that the FDIC will make a profit in some resolutions.

V - Market Discipline

All business enterprises, including banks, are subject to market discipline. This discipline is enforced through the actions of several different economic agents including:- customers, suppliers, employees, equity owners, and creditors. This section will begin with a description of how these agents act on commercial firms and on banks without deposit insurance. The causes of depositor runs in such an environment are then described. Deposit insurance prevents such runs, but at a cost of introducing new distortions. Several proposals have been advanced which seek to minimize these distortions by increasing the reliance placed on depositor discipline. These proposals involve the imposition of losses on large depositors of failed banks. This section ends with a discussion of the effectiveness of limitations of such policies.

Agents of Market Discipline

When the long term viability of a commercial firm is questioned (because of technological changes, loss of key employees, changing markets, etc.), the firm will have trouble maintaining its size. At the margin, customers will begin using competing firms or substitute goods in order to avoid future disruptions (spare parts, quality of service, etc.). Capable employees will start leaving for greener pastures. Financing will dry up for expansion projects, or only be available at high interest rates making fewer projects worthwhile. Suppliers will begin to focus more attention on other customers, perhaps resulting in a deterioration of the quality of resources. It will become difficult to attract new equity owners into the firm. Those whom remain intensify their scrutiny of the directors and top officials in order to maintain the value of their investment. There is constant pressure on the firm to reduce its operations. Unit costs may be driven up as scale economies are lost.

When the firm's short term viability is questioned, more direct pressure is placed on its cash flow. Customer defections will accelerate. Employees are laid-off in an effort to reduce expenses. Banks and other creditors will refuse to renew credit lines. Suppliers will demand payment in advance. If the firm is unable to withstand the pressure, and becomes inviable, it will enter voluntary or involuntary bankruptcy. At this time, outstanding obligations will be resolved in an administrative proceeding in which all creditors of comparable standing are dealt with equally. It is important to note that, although individual creditors may try to obtain as much payment as possible in advance of a bankruptcy declaration, their claims are generally not payable on demand. Therefore, there is no analogy to a bank run in a commercial firm. All of the agents of market discipline assist commercial firms with bright prospects and place obstacles in front of firms with dim prospects. These forces affect growth rates over the long term. Commercial firms do not walk along a razor's edge, facing certain death if they ever stumble.

The forced exiting of inefficient or obsolete firms improves the performance of the overall economy. Because banking is a vital sector of the economy, it is important that the vigor of the industry be maintained and enhanced through similar free market operations.

Depositor Runs

When the long term viability of a bank is questioned, (even in a world of deposit insurance) various market forces work to restrict the growth of the firm. Bank customers will also begin moving business to competing firms for many of the same reasons that the customers of a commercial firm do. The negotiation of credit arrangements is often firm specific and complex. Businesses will want to avoid having to repeat this process with the new owners of a bank's assets. The value of some bank products, specifically letters of credit, are tied to the bank's credit-worthiness. As this diminishes, customers of the bank are likely to establish relationships with other institutions. Employees will have the same set of incentives to leave as their counterparts in the commercial sector. In a bank, investors include equity holders, unsecured debt holders, and deposit holders. Equity holders and unsecured creditors in a bank will behave the same way as their counterparts in a commercial firm. Thus banks are subject to much the same discipline as commercial firms. The difference is in the actions of deposit holders, of whom there is no equivalent in a commercial enterprise.

Deposit holders can behave as customers (purchasing services from the bank), suppliers (funding is the raw material of a bank), and investors. Demand deposit holders are distinctive in holding callable debt. This distinguishes them from most debt holders of commercial firms. Their actions will differ from those of a commercial debt holder when the viability of the debt issuer is questioned.

A deposit holder has an incentive to liquidate deposits from a troubled institution if transactions costs are less than potential losses. Demand deposit holders face virtually no transactions costs. Therefore, any time that the solvency of a bank is questioned, uninsured depositors can be expected to run. The flight of depositors' funds could cause an otherwise viable bank to collapse because bank assets are illiquid. A bank that must sell its assets to honor the withdrawals will have to accept fire sale prices. As these discounts erode the net worth of the bank, a deposit run can become a self-fulfilling prophesy and lead to the collapse of the bank. Thus, a depositor who observes a panic run on his bank would have every incentive to join in the run, contributing to the bank's demise.

Deposit Insurance

The implementation of a deposit insurance system eliminates the incentives that depositors would otherwise have to run from troubled institutions. However, the improved stability does not come without a cost. Insured depositors face little incentive to monitor the riskiness of their institution. Bank managers can assume greater risks in their asset portfolio without experiencing an equivalent increase in the cost of funds raised by deposit. The additional risk is borne by the insurer. This moral hazard can be reduced through vigorous supervision. It can also be reduced through the activities of the other market agents previously mentioned.

Therefore, whenever it is believed that the banking industry has transferred an excess amount of risk on to the insurer, several policy responses are possible. Increased regulation and supervision is one avenue. Placing more risk on different market agents would also alleviate the pressure on the insurance fund. The ABA supports the efforts made by the FDIC to improve the training given to bank examiners and to increase their level of compensation. The ABA proposal also advocates that more explicit risk be shouldered by depositors by imposing losses on uninsured depositors in all failures.

Depositor Discipline

Dependence on depositor discipline to relieve the burden on the insurer can create undesirable side effects. These include: 1) an increase in systemic instability; 2) a loss of flexibility in limiting the economic damage of a major bank failure and 3) a competitive disadvantage for the US banking industry. In addition, 4) it is unclear that the bank deposit market is well suited to imposing discipline on banks.

1) Systemic Instability

A policy regime that mandates losses on uninsured depositors introduces instability because it increases both the possibility of bank runs and the ripple effects of the bank failure. As the pool of uninsured depositors increases, the likelihood of bank runs also increases, as does the potential for damage in any individual run. When failures occur, the losses imposed on uninsured depositors will have economic repercussions. These include possible impairment of correspondent banks, disruptions to the payments system, and damage to the local economy as firms and individuals adjust to their losses. Once again, the greater the pool of uninsured depositors, and the greater the loss at the failed bank, the greater the economic impact will be.

2) Regulatory Flexibility

Any policy that imposes mandatory losses on uninsured depositors only has meaning if it is expected to apply to all bank failures, including the largest. It is difficult to imagine that those who are ultimately responsible for macroeconomic stability would abandon the flexibility to handle a truly large bank failure on a case-by-case basis. If legislation prohibits the FDIC from acting with discretion, other government bodies - either the Federal Reserve Board or the Department of Treasury might act to support a major failing bank. In this event, uninsured depositors will be treated better than they would have been by the FDIC. The reality that the largest banks are more likely to receive such treatment will continue to influence market behavior, providing major banks with a competitive advantage over smaller institutions and reducing the effectiveness of depositor discipline on those large banks.

3) International Competitiveness

A policy of mandatory losses on uninsured depositors must be reconciled with policies followed by bank regulators in other major industrialized countries. Large depositors would have great incentive to transfer their funds into institutions that are believed to have more government support than others.

The ABA urges other nations to adopt policies that would place large depositors at risk in the major banks of their respective countries. The FDIC will host an international conference of bank regulators this fall. An ultimate goal of the conference is to start a process that will lead to international co-ordination of failed bank policy. It would be imprudent to institute mandatory haircut proposals before international agreements are reached.

4) Effectiveness of Depositor Discipline

Although the FDIC believes that depositor discipline can play a role in maintaining a sound banking industry, it is important to recognize limitations on the extent to which an institution's riskiness will be reflected in deposit rates. These limits are illustrated when the informational content of a bank's share price on the equity markets is compared to the informational content of a CD rate. The opinions of industry analysts will be fully incorporated into stock prices, because equity markets include short sellers as well as call and put option writers. The actions of investors who believe a firm's shares are overpriced will lower the share price of the bank's stock. However, only one position can be taken in a bank's certificates of deposit. A financial agent who believes that a bank has begun to pursue riskier or ill advised policies can not affect the market for the bank's certificates. There is correspondingly less information in the rates a bank would have to pay on uninsured deposits, reducing the value of the discipline imposed by those rates.

The ABA mentions that depositors would make better use of evaluations published by private bank analysts. While such a result would be an improvement, it is important to recognize that there are limits to the information provided by these firms. In many cases, analysts' forecasts are based on bank financial statements and analyzing performance based on key ratios compared to peer groups. This type of analysis offers some insight into a bank's current performance, but does not indicate as much about a bank's prospects. Bad loans and fraud continue to be the major causes of bank failure. Bad loans look good - and very profitable - for a long time before they turn sour. Only a few years before failing, Continental Bank was hailed as a model bank organization. The type of analysis required to determine the quality of a loan portfolio is so intrusive, it is doubtful that it could be performed by agents other than bank examiners. Even if the bank were willing to submit to the intrusion of such analysis, the need to maintain confidentiality of customer information may prevent a third party from making an accurate assessment of individual credits. Private analysis is not a substitute for the information reflected in a market generated price in which each analyst takes a monetary position.

Summary

1. There are many worthy goals of the [illegible] proposal, including the effort to overcome some of the technical and administrative problems in large bank failures, the equalization of the treatment of depositors at banks of different sizes, and the reliance on market forces instead of government intervention to control banks with excessive risk.

2. Banks, even under 100% deposit insurance, face forces of market discipline. Deposit insurance reduces the systemic instability of depositor runs at the cost of enabling bank managers to transfer risk to the insurer.

3. The ABA proposal recommends that depositor discipline be increased through the imposition of mandatory haircuts on uninsured depositors at failed banks. While the FDIC is in favor of reducing its exposure to loss, it is concerned that attempts to augment market forces through increased depositor discipline will extend the potential instability of bank runs and of aftershocks following a failure.

4. The FDIC is also concerned that, without international agreements, mandatory haircuts could result in a funding advantage for foreign banks which are perceived as being fully insured de facto.

5. Any system of mandatory haircuts must recognize the reality that, in truly large bank failures, those who are ultimately responsible for macroeconomic stability will retain the flexibility to handle the situation on a case-by-case basis. To the extent that depositors anticipate such intervention, the effectiveness of haircut proposals will be mitigated.

6. The FDIC has doubts about the legality of the method the ABA recommends to determine the percentage of loss to impose on uninsured depositors of failed banks. Any determination of the amount of loss to impose on uninsured depositors in a failed bank should reflect the conditions of the specific bank. A system which pays a fraction of uninsured balances based on experience in past failures would be questionable if, in individual cases, uninsured depositors received less than they would have in an ordinary payout.

7. Banks may not be able to quickly redesign computer systems and re-code account data to accommodate the overnight processing demands of the final settlement payment procedure. In addition, the costs to the industry appear to be considerable. However, the FDIC welcomes any development which reduces the cost of opting to pay off or transfer the deposits of a failed bank.

ATTACHMENT A - CHECK CLEARING SYSTEM

Whenever a bank's customer writes a check against his account balance, the check will eventually be physically presented to the bank for payment. The check may arrive from the following sources:

1) The check is presented over the Teller window for payment or deposit into another customer's account.

2) The check is included with other checks deposited by a correspondent bank for credit to the correspondent's account.

3) The check is received from a local bank clearinghouse in which member banks exchange checks drawn on each other. Members make daily settlement payments with the clearinghouse.

4) The check is presented by the local Federal Reserve Bank. The bank's reserve account at the Fed is debited for the amount of checks presented.

Whenever a bank receives a check drawn on another institution (as a deposit or payment) it must enter the item into a processing stream that ends at the drawee bank. Ultimately, the check will reach its destination through one of the above channels. The item may pass through several intermediaries before reaching the drawee bank.[1] These intermediaries may include correspondent banks, the Federal Reserve Bank in the initial bank's district, or the Federal Reserve Bank in the drawee bank's district.

Clearing items drawn on banks across the country can be costly. Banks are willing to incur this cost in order to avoid float loss. A depositing bank will attain funds for the check on the day that the intermediary expects to receive funds for the check. Because checks received throughout the day constitute large sums of money, the lost interest on a single day's delay can be significant. Therefore, banks are more concerned with the clearing time offered by correspondent banks than with the fees they charge.

As a bank's check volume grows, it becomes cost effective to build faster processing systems and more elaborate transportation networks. As these systems and networks grow, check clearing services can be offered to other institutions. Fixed costs are a significant component of these operations. High speed processing equipment and air transportation couriers can handle an additional check at a low incremental cost. Smaller banks are therefore unable to replicate the check clearing system of larger banks. In order to clear their items, they must piggyback onto another local institution's system.

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[1] The average check is handled by 2.4 financial institutions according to Bank Administration Institute, op cite.

Large banks around the country establish relationships with each other. Each bank will accept checks drawn on smaller, local banks that it receives from other large banks across the country. These checks are then cleared through local clearinghouses or other local channels.

In some markets, correspondent check clearing is very competitive with several banks offering services. In other markets, small local institutions and large banks in other regions are limited to one or two major providers.

Checks in process create large correspondent balances. If these balances were subject to a mandatory haircut in the case of the failure of the intermediary, banks would be among the first to run whenever there was a question about the viability of the intermediary. In some markets, alternative processors have the capacity to absorb the fleeing business without much disruption. In other markets, adequate alternatives may not exist.

ATTACHMENT B - BANK OPERATIONS TIMETABLE

The overnight processing schedule of a major bank might look like the following (obviously some banks will have two or three hour differences in start or completion times for certain functions):

3:00 PM Bank officially closes for the day. Tellers stop posting transactions on the current day's date. Lockbox Department (may have different cut-off time altogether) continues preparing transactions already in the building on current date. New deposits will be processed with tomorrow's date. Wire transfer desk closes.

9:00 PM Bank starts receiving large deposits of checks for clearing from local correspondents. Will be on receiving bank's books as tomorrow's activity.

10:00 PM Today's transactions from the branches and Lockbox Departments have probably been posted to a batch file. Lockbox Department begins to receive a large quantity of deposits from Post Office. These will be processed on next day's date. This inflow will continue until about 8:00 AM.

11:00 PM Batch file of day's transactions begins to post to customer file. May take some hours. Processing of checks received during the day continues until morning deadline at clearing house. Processing of items on tomorrow's date (from correspondents and Lockbox) continues until the following close of business.

Midnight Bank begins to receive deposits from major correspondents around the country to clear local items. Such deposits continue until slightly before clearing house deadline. If any checking account statements are going to be prepared the next day, system will begin sorting the appropriate checks into account number order. This processing could continue until the following afternoon.

3:00 AM (or later) Transactions have posted to appropriate accounts, system determines which inclearing items from previous day are potential return items.

5:00 AM System pulls out potential return items from previous day's work. Prepares reports for printing (balances, potential overdrafts, late payments, etc.).

8:00 AM	Bank receives transmission from Fed indicating the amount of items drawn on major accounts at controlled disbursement banks. Information is relayed to customers (generally by 10:00 AM) along with balance information from previous day and preliminary information about lockbox receipts for today that are already processed.
9:00 AM	Bank open for business. Tellers receive deposits, make withdrawals. Wire transfer desk open. System begins printing account statements for accounts with yesterday cut-off dates.
10:00 AM	Clearing house deadline. Inclearings received and posted to batch file for final posting at night.
2:00 PM	Deadline for account officers to make pay/return decisions concerning previous day's inclearings. Information about these decisions is input into the system during the next few hours.
9:00 PM	Regulation CC deadline to enter previous day's return items into system.

APPENDIX III - ANALYSIS OF PROPOSALS
TO LIMIT POTENTIAL FDIC LIABILITY

This appendix analyzes three deposit insurance reform proposals which could reduce the FDIC's potential obligations.

A. Limit the insurability of an individual's[1] funds to $100,000 per institution by eliminating ownership categories used for insurability (eg. joint accounts, testamentary accounts).

B. Limit the insurability of an individual's funds to $100,000 across all institutions at any point in time. This proposal could eliminate or maintain ownership categories. If the categories are maintained, each insurable account relationship would be limited to $100,000 across institutions.

C. Limit deposit insurance to a single lifetime entitlement of $100,000 per person. Again, this proposal could maintain or eliminate some ownership categories. Variations on this proposal could involve different time periods (eg. $100,000 of insurance every five years or six months).

Section I of this appendix describes the possible benefits of these proposals. Section II discusses two issues that need to be addressed when considering all three proposals. One is the effect of the possibility that the relevant authorities might elect to handle a truly large bank failure differently from the rules set forth in these proposals. The other issue is the distinction between market discipline and depositor runs. In Section III, the main body of the paper, each of the proposals will be described, its specific administrative requirements discussed, and its unique economic implications considered. The paper ends with a brief summary.

In considering these proposals, it is also assumed that the restrictions will apply across insurance funds, whether FDIC-BIF, FDIC-SAIF, or NCUA. If separate limits apply to deposits at each of these funds, depositors seeking to increase their protection will find ways to create deposit relationships at institutions insured at each fund. This would cause economic distortions as funds flow to institutions based on insurance rules rather than economic advantage.

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[1] In this paper, the term individual or depositor refers to both persons and business firms holding deposits at insured financial institutions, unless otherwise indicated.

I - Potential Benefits of Proposals

These proposals have a common set of worthwhile goals. To the extent that the proposals would be effective in achieving these goals, the economy and the banking industry would benefit. These goals include:

1. Increased Depositor Discipline.

A larger percentage of bank deposits should become uninsured. Depositors can be expected to exercise more care in selecting a bank in which to deposit their uninsured funds. This heightened depositor scrutiny may make it more difficult for bankers who take excessive risks to generate the funding needed to expand.

2. Reduced Failure Resolution Costs to FDIC.

If a smaller percentage of the total deposits held by banks maintains insurance, it may be possible that the percentage of insured deposits in specific failed banks will also be reduced. If this occurs, more of the losses in those failed banks will be shared by uninsured depositors, and less will be absorbed by the FDIC.

3. Equalization of Treatment Between Depositors at Large and Small Institutions.

If policy makers are able to follow the same set of rules in all failure resolutions, there will be an equal treatment of depositors at institutions of all sizes. This would eliminate any funding advantages that currently exist at banks which are assumed to have greater government protection than their competitors.

II - Concerns Common to Each Proposal

Effects of "Too Big To Fail" Perceptions on Proposals

In order for any of these plans to be effective, the FDIC[2] would have to commit to handling all bank failures in a manner which imposes losses on uninsured depositors. The credibility of such a commitment might be questioned by depositors who believe that the macroeconomic repercussions of major bank failures might motivate those responsible for macroeconomic stability to intervene in support of those institutions.

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[2] In this paper, FDIC, unless otherwise indicated, will refer to any insuring agency: FDIC-BIF, FDIC-SAIF, NCUA.

To the extent that large banks are perceived by the public as "Too Big To Fail" we would expect a flight of funds to large institutions. This movement of deposits would provide large banks with a lower cost of funds than small banks. This would be caused by distortions stemming from failure resolution policy rather than from a developed advantage in deposit generation. The result would be a sub-optimal allocation of financing across firms in the banking sector. If significant amounts of money are affected, small banks will have to reduce their activities due to a cutoff of funding while large banks would increase activity to accommodate these funds. This change in market shares would also result from a market distortion rather than a developed advantage in credit creation.

The public's perception of the protection afforded to large banks is not without foundation. In the past, public officials who were confronted with major bank failures have opted to act in a way that minimized short term economic disruptions. Officials in different administrations and nations have reacted in similar ways. These proposals do not directly address the concerns which motivated the policy makers to act as they did in the past. If such actions are repeated in the future, we will not have reduced the total potential public liability. Rather, the composition of a portion of the potential liability would have been transferred from deposits at small banks to deposits at large banks.

Depositor Discipline vs. Depositor Runs

These proposals would create a larger pool of deposited funds which is at risk in the event of a bank failure than exists today. Appendix II describes the concerns we have about the effectiveness of depositor discipline and the potential instability that may be introduced into the banking industry by exposing depositors to greater risks. These concerns also apply to the three proposals.

III - Implications for Each Proposal

The above discussion would apply to all three of the proposals. Implications of each specific proposal are discussed below.

PROPOSAL A - ELIMINATE INSURABILITY CATEGORIES

Current regulations establish complex types of ownership categories, each of which is separately insured at a single financial institution. For example, the joint account of a husband and wife is insured separately from individual accounts that they may keep. Furthermore, revocable trusts can be established (by signing the appropriate signature card at the bank) that are also insured separately - but only if the beneficiary is a spouse, child or grandchild of the trustee. Such trusts established with great-grandchildren, nieces or nephews as beneficiaries do not qualify for separate insurance. Apparently, these regulations have been adopted in response to statutory provisions that suggest insurance be based on ownership capacity. Certain ownership capacities are specified by statute.

An alternative system would mandate that a single tax ID number or social security number be attached to every account to indicate insurability. Regardless of ownership type, only $100,000 (or some other prescribed amount) would be insured for that individual or firm. Such a change would probably have little economic impact. Wealthy depositors (with sufficiently large, qualified families) who currently utilize the system to insure more than $100,000 in a single institution could spread those accounts across several institutions. However, such a change might effect the provision of pass-through insurance that is currently available to certain pension and employee benefit plans.

This proposal could make a payout resolution easier and quicker by streamlining some of the administrative tasks. It would also ease the burden on financial institutions should they be required to maintain and report accurate information about the insurance status of their depositors. This increases the set of institutions for which the FDIC might opt to pay-off insured depositors in the event of failure.

PROPOSAL B - RESTRICTION ON INSURANCE IN MULTIPLE INSTITUTIONS

There are two general ways to design this type of plan. With the first method, depositors designate, in advance of any failure, which specific institutions or accounts are to be insured. An alternative method limits coverage of any individual depositor as multiple failures occur in institutions used by that depositor. The second method would not reduce insured funds as much as the first. Depositors could maintain accounts for the maximum amount at several institutions in the hope that no two of them would go into receivership simultaneously.

Specific procedures that appear necessary to implement each proposal are described below. Each of these systems would involve administrative burdens that are not presently incurred. In addition, there are economic implications to consider with each system.

Method 1.

Description

Individuals must designate in advance which specific accounts in which specific institutions are to be insured. The total of these accounts may not exceed $100,000. Any other deposits at the designated banks or at other banks would not be insured. When an institution is put into receivership, designated deposits would be insured, but all other deposits would not be insured.

Administrative Requirements

There would have to be some controls established that would prevent individuals from intentionally or inadvertently insuring funds in excess of the $100,000 limit. This task is complicated by the dynamic nature of bank deposits. Not only do customers change institutions, depositors may also switch their savings among different accounts within the same institution (eg. from short term CD's to long term CD's or money market accounts), and balances within accounts also vary over time.

Presumably individuals would wish to insure the balances of their checking accounts in order to avoid situations in which checks that are in process are returned by the failed bank. However, these balances fluctuate by considerable amounts throughout a month or year. As investment funds are liquidated or reinvested checking account balances can experience major changes. As salary is deposited, and then spent through the payment period, smaller shifts will occur. An individual who anticipates that his checking account balance would seldom exceed $10,000, might designate the checking account and a $90,000 certificate at another institution as his insured accounts. However, the depositor will be exposed whenever larger amounts of money are flowing through the checking account or there is a delay in the processing of checks he has already written. The insuring agencies would need to have access to records that indicate the pre-designated amount of each account that is insured.

In addition, the designated accounts and amounts at the failed institution would have to be verified against a master file that contained all such designations in all institutions to prevent excess designation by individuals. Penalties would probably need to be established (criminal or civil) for individuals who intentionally over designate in order to increase coverage.

Depositors would have to be allowed to switch designation among institutions. As concern over a specific bank's viability began to spread, depositors with time accounts at that institution would want those funds to be designated (protected) regardless of their deposits at other institutions which may have been previously designated. Whenever a bank failed, FDIC would have to verify that depositors with designated accounts at that institution had not designated other accounts at other institutions in excess of their limit. Because such designations are changing daily, FDIC would need to maintain a database of account designations that is continuously updated.

In order to keep the file current, FDIC would have to receive these changes electronically, rather than on paper. This suggests that banks would become responsible for reporting designated accounts, balances and ownership on a daily basis. However, this could create problems in verifying that the data provided by a bank is consistent with the desires of the customer. FDIC would have to audit the veracity of reported information. All incoming data would have to be compiled daily by the FDIC to verify that individuals have not designated excess funds, and to have accurate information whenever a failure occurs.

Because individuals would be responsible for the accurate designation of their account balances, they would need to have access to the information kept on the master file. However, there are real security and privacy concerns raised by this requirement. FDIC would not be able to verify the identity of any inquirer. However, the potential for fraudulent use of the data released (Bank, account number, balance) is significant. Conceivably, information requests could be channelled through banks, however, depositors may not want a bank to know what other accounts are being held at competing institutions.

Economic Implications

The reporting requirements imposed on the banking industry could be onerous enough to act as a tax. The costs of this burden would be passed on to customers in the form of lower yields on bank deposits and higher loan rates. Maintaining the data base that would run this system would impose heavy costs on the FDIC. These operating costs would be reflected in the insurance premiums assessed to banks.

These burdens could impose deadweight drags on the banking sector and make it less efficient relative to other types of financial intermediaries. To the extent that this occurs, activity would flow away from the banking sector toward other types of financial service providers. This flow would not result from any economic advantage created by the competing industries. It would be a direct result of the burdens this proposal places on banks.

Method 2.

Description

Accounts at all institutions currently in receivership are combined and analyzed for insurability using a process similar to what currently occurs within a single institution.

Example 1: Joe Jones has $100,000 on deposit at Bank A, Bank B, and Bank C ($300,000 total). If any one of these institutions goes into receivership, Joe's funds would be insured.

Example 2: Same as example 1, but Bank A goes into receivership. After Bank A is taken out of receivership (either through a P&A or payout), Bank B fails. Joe's funds in Bank B would be insured.

Example 3: Bank A goes into receivership. While A is still in receivership, Bank B fails. When we analyze the accounts at Bank B, we see that Joe already has $100,000 in receivership held funds, so the funds in Bank B are not insured.

Example 4: Same as in example 3, but after Bank A is settled, Bank C fails. In this case, analyzing accounts at Bank C indicates that Joe no longer has funds protected in a receivership (the funds in Bank B had lost their protection). Joe's money in Bank C is protected.

Example 5: Same as example 4, but Bank B is settled first. Before Bank A is settled, Bank C fails. Joe still has money protected by FDIC receivership (from Bank A), therefore the money in Bank C is not protected.

Administrative Requirements

At present, the FDIC scrutinizes the ownership arrangements of accounts for insurability only in payout situations. Generally, all depositors are given immediate access to a portion of their funds. In order to avoid over-insuring depositors with more than $100,000 in the institution divided among two or more accounts, the bank's records are carefully scrutinized. After one or two days (in the case of a small institution), the various balances are aggregated by owner and insurability is fully ascertained. The insured balances are paid out at that time. The larger an institution is, the longer this process takes.

Because uninsured as well as insured depositors are kept whole in purchase and assumption resolutions, such record keeping is not presently performed during most bank failures. Using Method 2 to reduce FDIC exposure would require that the record keeping take place in every receivership, even those ultimately resolved through purchase and assumption. Otherwise, when resolving any other contemporaneous failures, FDIC would be unable to identify when it was in situations like examples 3 and 5 above (the only situations in which FDIC coverage would be reduced from current levels). Administrative costs of failure resolution would increase as the intensive record keeping burdens are assumed in all cases.

The lengthy amount of time it takes to accurately sort out and aggregate the ownership of accounts in an institution creates several problems. First, holding failed banks in receivership for longer periods of time may reduce their franchise value.

Additional technical problems might also occur. Returning to the example situations described above, assume that Bank A goes into receivership. Under current practices, a P & A transaction could be arranged after one week. However, two weeks are needed to complete the record keeping required by the new system. Bank B fails during the second week. Is this a case of Example 2 or Example 3? Would depositors accuse the insuring agency of keeping Bank A in prolonged receivership in order to reduce potential liability when another institution failed?

There are also potential inter-agency disputes. If a regional economic downturn threatened the viability of institutions insured by all three funds (FDIC-BIF, FDIC-SAIF, NCUA), each fund would have an incentive to wait until another fund began closing institutions. The first fund to act would become Bank A in the above examples while succeeding funds would become Bank B for many common depositors.

An alternative device which would speed the handling of a failed institution would be to require that banks keep up to date account records on insurability of accounts in a standardized format so that insurance liabilities are rapidly identified during a failure resolution. The records would have to be in an electronic format so that the file from any failed institution could be quickly compared to the files from other institutions in receivership.

Economic Implications

Individuals with more than $100,000 in bank deposits would probably get skittish whenever there was an economic downturn or threat to the banking sector. Because they would be unsure of the viability of any institution, they would have incentive to move their funds to large banks where there is a "Too Big To Fail" perception. The lack of confidence could also intensify regional economic disturbances. Fearing that the banks in the distressed region were weakened, and more likely to fail than previously, depositors might transfer funds out of that area of the country. If this occurred, it would cause funding problems for the banks and intensify a local credit crunch.

The deposit outflow would become especially strong whenever a bank is put into receivership. Depositors at that bank who have more than $100,000 in the banking system would lose some or all of their protection at other institutions until the failure is resolved. They will have incentives to run, adding instability to the system.

Even depositors whose banks have not yet failed, but who have more than $100,000 in deposits at various institutions would have incentives to panic. Because they would be in a more precarious state after one of their banks closed, they would have incentives to run from any bank that got into trouble.

PROPOSAL C - RESTRICT LIFETIME INSURANCE ELIGIBILITY

Suggestions have also be made that deposit insurance should be a once in a lifetime entitlement. Under such plans, a person would be protected from successive bank failures until the sum of the deposits in past and present failed institutions equalled a cut-off level (eg. $100,000). After that point, the depositor's funds would not be insured. Variations of this proposal could shorten the time period that the individual would be uninsured. For example, every five years an individual would be insured for $100,000. The administrative and economic implications of these plans would be similar.

Administrative Requirements

It would be necessary to maintain records of all depositors at failed institutions and the balances of their accounts. Whenever a failure occurred, the insurability of accounts would have to be determined in the manner described on page 8 above. If the failure is to be resolved through a payout of insured depositors, the accounts records of the institution will have to be compared against the historical file of depositors at failed institutions before final determination of insurability can be made. In the case of a purchase and assumption transaction a rigorous analysis of account records will also have to be undertaken in order to record which depositors have extinguished their insurance benefits.

As explained in the discussion of the previous proposal, the time requirements of completing such an analysis can reduce the franchise value of the failed institution. Such delays could be avoided by imposing requirements on banks that they maintain, in standardized electronic format, timely and detailed tracking of the insurability of depositors accounts.

Special problems arise under these plans in dealing with corporate entities. Presumably insurance entitlement for corporations would be based on tax payer ID numbers. However, what controls would prevent a business from reincorporating in order to obtain a new TIN and thereby renew insurance protection? Also, how would other forms of corporate re-organization (mergers, spin-offs, acquisitions) effect the new entities' insurance entitlement?

Economic Implications

Under this type of plan, depositor behavior would be very similar to behavior without any insurance program. There would be two groups of depositors, those whose insurance benefits have been exhausted and those who still have some or all of their entitlement remaining.

The first class will behave in a manner as destabilizing as if there was no deposit insurance at all. The second class of depositors would also have an incentive to withdraw funds before their institution failed. In a failure, these depositors would keep their money but lose something else of value - insurability. Therefore, the proposal would eliminate the major benefit of a deposit insurance program - stability - while creating formidable administrative burdens on the insurance agency (and probably on the banking industry too).

SUMMARY

Each of the three proposals have worthy goals. These include: increasing depositor discipline; reducing FDIC expenses and; equalizing the treatment of depositors at large and small institutions.

There are issues which need to be considered prior to implementing any of these plans. If depositors in the largest banks continue to be perceived to be immune from loss, the uninsured funds will shift from deposits in small institutions to deposits in large institutions. Should the perception prove to be true, total public liability will have also shifted instead of being reduced. In addition, to the extent that the proposals might be successful in creating a larger pool of uninsured deposits, instability will be increased in the system. The overall benefits of these plans are uncertain.

On the other hand, the costs will probably be significant in new administrative burdens placed on insuring agencies and probably on the firms within the industry. Economic distortions may occur as funds move to other financial service providers that are not similarly burdened. Additional distortions would be expected to occur as funds within the industry shift to larger institutions.

The **Chairman**. Very good. You covered a lot of ground, and you made a number of very sweeping recommendations, albeit, with provisos attached to them.

Senator Graham, did you have an opening comment you wish to make?

Senator **Graham**. I have no opening statement, Mr. Chairman. I appreciate Mr. Seidman again giving us the benefit of his wisdom.

The **Chairman**. As we move into this, I want to understand better where we are right now with respect to the insurance fund. And so I want to ask you some questions about that.

The press recently quoted you as saying that the insurance fund currently is, and I quote, "under considerable stress." And in the future "would be in trouble" were the Nation to suffer a serious recession.

And we've been trying to get a clear sense as to what the current state of the insurance fund is and whether the reserves there—talking about the bank side now—are adequate for the years ahead.

Just to set that question up, my understanding is we've got something on the order of $2½ trillion of deposit liabilities out there, and we've got that resting on the deposit insurance fund right now of about, I gather, $12 billion or $13 billion. Is that more or less accurate?

Chairman **Seidman**. That's correct, yes.

The **Chairman**. Well, can you give us a sense as to what those trend lines look like, and you've got a reputation for candor, and I'd like you to be very direct about it and without scaring people to death. So——

Chairman **Seidman**. Well, I suppose I'll never really learn, Mr. Chairman, but I'll try my best. Clearly the insurance fund is under stress because its coverage is at the lowest point it has been at any time in modern history. And that's because we've suffered in the last 2 years.

And, at the present time, as you are aware, we continue to have over a thousand problem banks, and we continue to have failures in the system approximately equivalent to what we had last year. As far as we can tell now, the fund is adequate to meet any failures that we can identify at this point.

What we do is we go over the problem bank list, which are all the banks that we believe are in trouble, and we try to identify those that actually will fail. We estimate the cost of that, and then we estimate whether the fund can handle that cost.

Our present view is that we can handle that cost, although we may have another loss in the current year. That will put further stress on the fund because it will lower us from about a 0.7 coverage or 70 cents per $100 down to some number in the 60 to 50 cent range.

So I think it is clear, as I've said, that the fund is under pressure. At this point, we believe we can handle what we see in the system at this point. But, like anyone else, we are not able to predict the future perfectly. We monitor it on practically a daily basis, and should we see things that we believe jeopardize our ability to handle the situation, then we would certainly make that known to you.

The CHAIRMAN. Now it appears—you told us the last time you were here in the report that was delivered in your absence that this decline in real estate values is sort of moving around the country. It's in some areas now. It seems to be spreading to a broader geographic area. New States, in effect, have come into the listing of States where there's been a major downward adjustment in real estate values.

I'm wondering what your latest reading is on the erosion of real estate values on a broad base as they would affect the asset values on bank balance sheets and the degree to which we would be seeing an increase in nonperforming loans or write-offs or loan loss set-asides and things of that kind that would point us in the direction of an increasing picture of stress from that source?

Chairman SEIDMAN. I don't have the second quarter figures yet, but everything that we see indicates that there's a continued erosion in real estate markets in a large number of areas in the country. And those areas where they're not eroding are largely areas where there was a very substantial erosion and they bottomed out.

As you may be aware, we put out a chart each quarter showing the areas where banks are having trouble with real estate loans, and that shows the worst areas in red, the rest in pink, and the good areas in light. And there are, I would predict, practically no white areas left at this time.

In other words, it is a generalized problem. Some places are bottomed out. A few places have not felt the problem—and that has been primarily places where there hasn't been a big increase in building and increases in value.

I'm referring primarily to commercial real estate rather than housing. The erosion in housing is less nationally than in the commercial area. But, as you know, we put out some statistics on this some months ago indicating areas that looked like they were overbuilt and where building continued.

And those areas that we pointed out are clearly reflecting now the statistics that we presented.

The CHAIRMAN. Has this thing hit California yet?

Chairman SEIDMAN. I think it's clear that areas in California in the commercial area are beginning to reflect a readjustment. On the other hand, the California economy continues strong, and that will have a balancing effect.

But, yes, we can say, in general, the California markets are no longer going up, in some areas that we see some erosion.

The CHAIRMAN. Now this, it seems to me, relates to your argument earlier where you were talking about broadening out the investment options for banks and how you protect the fund at the same time.

Is it a fair summary to say that, in recent years, these things like commercial paper and other things that banks used to do have been peeled off, that their move out in the commercial lending, commercial real estate lending, has increased partly because that's been one of the avenues where they thought they could make money, that they could generate profit and capital and attract new investment capital and so forth?

And what I'm wondering, having lived with this so long, whether now the susceptibility of banks to that real estate risk in commercial real estate may be of a much larger size than maybe we're accustomed to thinking about it partly because of this evolution in the nature of the banking business and the fact that there may be quite a large number of banks out there that are susceptible to major difficulties if you get a serious lowering of real estate values.

Is it accurate to say that that is a central part of this problem that we're seeing develop here?

Chairman SEIDMAN. Well, it certainly is a central part of the problem with some banks. I think we have to be very careful not to apply this to all banks, because banks are very different.

But, overall, the percentage of loans that are involved with real estate and banking over the last 15 years has doubled. And, therefore, banks are up to the 35 and 40 percent area in terms of the loans involved with real estate. And that means that real estate values are very much more important to them.

Changes in interest rate risks are harder to protect against. And the nature of the industry has changed. Anybody who looks at the reported earnings of banks around the country in the second quarter will see an erosion in many, not all, but many banks' earnings directly related to real estate values.

So it is a changed industry, and real estate has a far more important effect. And very frankly we have probably the weakest real estate market overall in this country that we've had for many years.

The CHAIRMAN. Well, and it seems to be spreading.

Just one other thing very quickly, and then I'll yield. But I want to try to finish this in a sequence.

When you said earlier that we may see a further depletion in the insurance fund and where we've been at about 70 cents per $100 that we might be down at the end of year somewhere between 50 and 60 cents.

Where is the point at which, or are we at the point, where we ought to be thinking about increasing the insurance that the banks pay so that we put more money in the fund?

Chairman SEIDMAN. Well, of course, banks are paying increased amounts and will increase again next year as a result of FIRREA, but I think our Board will be monitoring that very carefully, and obviously that's an action that they will be looking at if they think it is required with the results of the year.

The CHAIRMAN. So you're testifying, you're saying the net reserves still shrink despite additional premiums being paid in, so we're not staying even. We're still sliding backward to some extent and——

Chairman SEIDMAN. Well, that is a potential. I don't know how we'll end up for the year, but there is that potential based on what we see at this time.

The CHAIRMAN. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Chairman Seidman, as we talk about the need for restructuring, modernization, deregulation, and attempts to come up with some consensus next year, one of the obvious reasons or excuses used for not doing anything is one that I hear every single day.

And it obviously relates back to the S&L crisis, and people say, "Why would you possibly want to do anything in the way of restructuring the financial system in light of the fact that deregulation is the cause of the entire problem?"

And I recognize that this is a very complex subject, and it's difficult for the press or individuals to go back to the decade of the 1970's and look at the Fine and the Hunt Commission reports and recommendations of both the Ford and the Carter administrations, but if people do that, they will find that this is not a problem that started in 1980 or 1982.

If I just read the press today and I came from Mars, I would guess I would conclude that this started all in 1980 and nothing happened before then, that the edge of the Earth occurred in 1980 and 1982 and from then on. And, obviously, that is not true and the record fully shows through all these reports that were commissioned by previous administrations and Congress' that attempts to try to deal with the interest rate mismatch of borrowing short and lending long were the root of all of those problems.

And I understand when a problem is this severe that people want to find individuals or groups to blame. One of the things that, I guess, amazes me more than anything else is when I consistently read at least once a week and in some very major national magazines that Garn-St Germain was the cause of the problem. Statements like "obviously the cause of the problem."

Well, believe me, in hindsight, if I had known what was going to happen, I certainly would not have allowed the House of Representatives to put my name on that bill, because nobody talks about the Deregulation and Monetary Control Act of 1980.

Bill Proxmire was smart enough one way or another that his name was not on the bill, and I wish mine was called something like that, and that four-letter word "Garn" was not on it.

But the thing that amazes me is to continue to have that said, and I'd like to know whether you agree or disagree with those comments?—you've been around during most of this period of time and know that, the 1982 act, Garn-St Germain, is still the law of the land, with two amendments that we made. So I would assume that Congress, with all of the anguishing we went through last year in trying to produce FIRREA, that we would have repealed it if it had "been the cause of the problem."

As a matter of fact, both the 1980 and 1982 acts are virtually intact as good public policy. Most of them were granting additional powers to the regulators for interstate acquisitions, mergers across State lines for troubled institutions, and so on.

Deregulation absolutely is a major cause of this problem. And it is correct for everybody to talk about it. But it also is correct to say that that the deregulation that caused the problem occurred in the State legislatures of this country, particularly in two States, Texas and California.

As a matter of fact, the OTS statistics of just a month or so ago indicated that 73 percent of the entire cost attributable to the last 4 years had occurred in State-chartered institutions and that, amazingly enough, 69 percent of those losses occurred in just two States.

Not 69 percent of the 73, but 69 percent of the entire losses occurred in Texas and California, which went far, far beyond any Federal law, the 1982 or 1980 act or previous acts, in granting powers that were excessive and dangerous and have certainly proven to be so.

So I guess the major point I want to make in looking at the need to be competitive is not to have Federal law used as a scapegoat to prevent the necessity of modernizing our financial structure, so a long time after you and I and this committee are no longer here, we have a financial structure that is competitive, not only domestically, but internationally as well.

So I'd like you—as the chairman said, you've always been very candid—to suggest in this area how you feel, and don't be led by the comments that I have made whether deregulation that occurred in the State legislatures, is a major cause of the problem? I don't know of any members of this body who have been, during that period of time, members of State legislatures; I'll take blame or credit for what I do here, but I've never been a member of the California or the Texas legislatures. If we should allow this myth that continues to be written about it may deter some very, very vitally needed future modernization and deregulation of our financial structure.

Chairman SEIDMAN. Senator, my candor doesn't go to the extent of trying to identify any one reason for the debacle that we're in—but I think it is interesting to note that we're not in a similar problem in the banking industry with regard to State institutions.

And that's because the basic structure is different, was handled differently. With regard to State banks, no matter what the bank may authorize them to do, the insurance fund regulates them and does not allow them to do anything that they believe jeopardizes the insurance fund.

And, therefore, if you look at losses in the banking system, you will not see the great majority in State institutions, although many of them have certain additional powers, you will not see the same thing that you saw on the S&L side, where the States authorized all kinds of activities. The insurance fund insured them without any real supervision. And many of them, obviously went wild, grew at tremendous rates and went into all kinds of very hazardous activities.

But I think it's very important to look at the fact that we had in the banking system the same potential for the States running wild, and they were not allowed to, because the insurance fund had as its assignment to see that they did not insure State activities that threatened the fund.

And so I think it is important in looking at this situation to come out—I come out—with the bottom line that the insurer is the one who is putting the taxpayer at risk. So the insurer ought to be able to determine what he has to insure.

Now I have differences with my friend, Bob Clarke, because under the present rules he can charter a bank and we have to insure it. We can't exercise a judgment. Now, with Clarke there, I'm not worried.

But, as a fundamental principle, I believe that the insurer should be like you would be in the private sector. And he wouldn't insure somebody who has 50 speeding tickets and 25 wrecks. And, yet, under the system that was put in place there, that's what took place.

So I think that when we look at that, the bottom line is that the Federal Government's interest as the insurer is seeing that they do not insure unsafe and unsound activities. And clearly that was not done in the S&L industry. And that's where the problem was.

Senator GARN. If I could just summarize your answer there, it is clear that Federal law was not the cause of the problem, that it was State law. And a big mistake that was made by Congress was not in the passage of legislation, what we allowed Federal institutions to do, but was to go beyond that in our belief in State rights.

And I still feel that way, that a State legislature, Governor, ought to be able to do anything they want within their State. However, as you have pointed out, where the big mistake was made was we should have said, "Fine, States. Do anything you want, but not with Federal insurance."

And that's where FSLIC, Congress, made the mistake. We don't care if you want to be in mushroom farms, but we will not insure it.

Chairman SEIDMAN. Exactly.

Senator GARN. And that distinction was made with the banks. So if some people want to focus on one thing that was a major mistake, we simply should have said, "You can't do that with Federal insurance."

Chairman SEIDMAN. And I'd just point out again that we did do that on the banking side, and we didn't have the same problems. So we had a control, almost like a scientific control, which shows that it can be handled, but it couldn't be handled in the way it was with the S&L's.

The CHAIRMAN. Well, and the record should show that we took care of that in FIRREA. I mean, we shut that door and so it's not that way any longer. But that doesn't take us back and retract the 1980's unfortunately.

Chairman SEIDMAN. Yes.

The CHAIRMAN. We've had two other Senators join us. Senator Wirth is next in the questioning, but before I call on him for that purpose, Senator Dixon, did you have an opening comment to make?

Senator DIXON. I'd appreciate your placing my statement in the record, Mr. Chairman, and I'm delighted to have my old friend, Mr. Seidman, here giving us the benefit of his expertise.

The CHAIRMAN. Very good.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as we continue our hearings on modernizing the regulation of financial services. We have two distinguished witnesses before us today, and I look forward to their testimony.

There has been a lot of discussion about deregulation in recent months. Many commentators argue that deregulation was a major cause of the thrift crisis. I do not intend to discuss that issue this morning, except to note that what we are talking about here is not deregulation at all. Instead, what we are discussing is how best to bring our statutory framework into line with current economic realities. What we are discussing is how to adjust the so-called "safety net" and how we can adjust that safety net to encourage banks to be more prudent and to put more market discipline into our banking system. What we are discussing is what we need to do to ensure that our banks have a fair opportunity to compete with their foreign counterparts—both here and abroad—while maintaining the safety and soundness of our banking industry.

These are important subjects, and they deserve our attention. That is why these hearings are so important. We can no longer afford to delay acting any longer, and that is why it is so important for this committee to hear the views and recommendations of the distinguished Chairman of the Federal Deposit Insurance Corporation and the distinguished Comptroller of the Currency this morning.

The **Chairman**. Senator Sanford, did you have an opening comment?

Senator **Sanford**. Well, I have a statement. I don't believe I'll take the time to read it. Just put it in, if you don't mind.

The **Chairman**. Without objection, it will be made a part of the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator **Sanford**. Thank you, Mr. Chairman, and let me once again congratulate you on putting together this very important series of hearings on the modernization of the financial services industry and deposit insurance reform. The long list of very distinguished witnesses you have brought before this committee has been both impressive and very helpful to all of us as we try to put together proposals for a financial structure which offers not only competitive strength throughout the world, but also security for every American who wishes to keep his or her money safe in a neighborhood bank.

Over the past few weeks we have heard much discussion of America's slipping position in an increasingly competitive global marketplace. As everyone here knows, the United States is nursing budget and trade deficits, a decline in world market share for high technology goods, and of course the tremendous crisis in our savings and loan industry, just to name a few of our woes. And as we struggle, the European community consolidates their economic strength, Japan continues to gain momentum, and communism is falling throughout Eastern Europe. The message is clear—the United States is lagging behind, and we must catch up if we want to continue as a world power. But without a sound, modern financial structure, we have no foundation for an economy which can compete in this rapidly changing world.

Today, on the conclusion of this series of hearings, we once again have the opportunity to hear from two prominent figures in the financial sector on how we can reverse this disturbing trend. Chairman Seidman and Mr. Clarke, let me thank both of you for being here today to share your valuable insight into the problems facing the U.S. financial services industry. I am sure that your testimony will help clarify the situation now facing us in the financial services industry, and also help us to sort out the numerous proposals for reform.

I am especially interested to hear your views on the importance of deposit insurance reform in the overall restructuring of the financial system. Thanks to the estimated $500 billion crisis in the savings and loan industry, we have learned the hard way about the extensive and potentially crippling liability inherent in Federal deposit insurance. While I understand that reform of the insurance system must be a part of a larger package, I feel that actually limiting the size of this tremendous liability—through a lower insurance ceiling or better definition of that ceiling—may be appropriate.

Again, I applaud you, Mr. Chairman, and I thank both of our witnesses. I look forward to hearing your testimony and the questions and answers which I am sure will follow.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Seidman, I was like so many other people very struck with your testimony yesterday on the increased needs to the taxpayer cleaning up the S&L mess.

In your testimony yesterday, in your written testimony, you said that the RTC would need a minimum of another $50 billion in the 1991 fiscal year to cover losses on the insolvent thrifts. That's in addition to $50 billion that has been spent so far. Is that correct?

Chairman SEIDMAN. It hasn't all been spent. At the present time, we've spent about $40 billion of the $50 billion, but it is in addition.

Senator WIRTH. But that will all be—that $50 billion will be gone and this is another $50 billion——

Chairman SEIDMAN. That's correct.

Senator WIRTH. For 1991?

Chairman SEIDMAN. 1991 or perhaps a little beyond, but——

Senator WIRTH. We know that these costs are mounting, and I went back and looked at some of the record on trying to determine from the committee's point of view what it was. And the committee in a letter from the chairman to you on June 8, 1989, wrote and said we do not believe that the $50 billion that you've requested over 3 years is going to be adequate. And your response on June 26 was that at this time we believe that $50 billion is enough.

The committee also wrote to Secretary Brady on May 25, and Secretary Brady wrote back in no uncertain terms:

> I continue to believe that the resources provided by the administration's plan are adequate. As a practical matter, it's doubtful that the RTC could efficiently spend more than $55 billion on resolution costs over the next 3 years.

Secretary Brady came back to us as recently as just 1 year ago saying: We can't spend more than $55 billion over 3 years.

Well, we've now spent $100 billion over about a year and a half in the resolution of these, or it appears that that's what we're going to be spending.

Can you tell us, one, how high do you think this cost is going to go. If we said $50 billion last year—you're saying yesterday $100 billion is going to be needed this year and maybe some of that will spill into the next year—what's the total cost of this going to be, do you think?

Chairman **Seidman**. Well, no one knows that, because obviously it depends on future events. But let me just refer to the letter which you just quoted. I think you will see in there that we made the point that no one will really know what these costs are until we get into all the institutions and actually evaluate them.

We are doing that now. We expect to be able to report to the Congress on that sometime in August. Now Secretary Brady has testified—and we're just talking about the RTC now, not about the total cost—he has testified that his estimate now is somewhere between $90 billion and $130 billion for the RTC alone. And I would say that our evidence so far and our on-site examinations will come within that range.

Senator **Wirth**. You're already over the $90 billion now. You were over the $90 billion without completing this review; right?

Chairman **Seidman**. That's correct.

Senator **Wirth**. This low end has already been passed.

Chairman **Seidman**. Well, yes. I'd say between the $90 and $130 billion is $110 billion or something like that. But, yes——

Senator **Wirth**. I think that was 6 weeks ago from the Secretary of the Treasury. We've already gone by that. I mean, his estimate of even 6 weeks ago is already outdated.

Chairman **Seidman**. Well, no, his estimate was $90 to $130 billion, and I still think that's a pretty good estimate. But I have to point out to you—and even when we've made this on-site examination—what do we do? We go in and we look at the loans and we look at the collateral behind them and we try to value them to see what the losses are.

Now we've just had a long discussion about real estate markets. And, obviously, as those markets change, that affects the loss. It not only affects the loss in the institutions that we believe are going to fail, but it affects the loss in other institutions that might not fail if the markets were not eroding.

So we're looking at a moving target, and no one will ever be able to know what the total cost of this is going to be until it's all done. And that will be a long time from now. So we are giving you the best estimates we can based on interest rates as we see them now, real estate markets as we see them now, the number of institutions that we believe are going to fail.

Now were we wrong before? Clearly we were wrong before. Were we trying to subvert somebody with that estimate? No. We were trying to give you the best estimate we could, but, one, these institutions are in worse shape than we knew, because we were relying on call reports. There was not a good examination force looking at them. So we had to rely on call reports and those were overoptimistic.

Second, it was in a different marketplace than we're now looking at, and that has a double effect. It increases the cost of institutions that we knew were going to fail, and increases the number of institutions that are going to fail.

So that's the best I can do to explain to you why we have come out where we are.

Senator **Wirth**. Well, we have, I think, a history of this. And I'm not suggesting you've been trying to subvert anything or have dissembled or whatever it may be. I know that there are problems in accuracy, but it does seem to me a bit difficult to try to explain to our constituencies that the Secretary of the Treasury made an estimate of $50 million over 3 years just a year ago.

That was $50 million for a 3-year period of time. We are now at $100 million over a 2-year period of time.

Chairman SEIDMAN. Billion.

Senator WIRTH. I mean, this is missed by, not a factor of 50 percent or a factor of 100 percent, but a much, much larger gap than that.

Now, are the American people sitting back there saying, "Well, Mr. Brady missed by 2½ times in a year factor. And he says, now $90 to $130 billion. Could this be $200 or $250 billion? Is that a possibility that that's where we're headed if he has low-balled on a steady basis so far? I mean, could we end up with something that's significantly higher than even we're suggesting in his estimate of 6 weeks ago?"

Chairman SEIDMAN. Well the Secretary and I—or our institutions have not always agreed on these estimates——

Senator WIRTH. Do you think it's higher than his $90 to $130 billion?

Chairman SEIDMAN. No, as I've just said, we have no information now to believe that his $90 to $130 billion in losses on the RTC is an unreasonable estimate. From everything we know at this point we think that is a reasonable estimate. Now it's a very wide estimate, obviously, and it depends on what happens to these markets, as he said.

Could it be higher than his highest number? Well nobody can guarantee that it won't be. But from everything we know now I would say we believe that's a reasonable estimate.

Senator WIRTH. But it could go significantly higher. If we see real estate crumbling—as apparently that's happening in other areas of the country outside of the southwest and we're seeing real weaknesses there—could it escalate quite dramatically?

Chairman SEIDMAN. If problems in the real estate market get worse, the costs will go up.

Senator WIRTH. All right.

Mr. Chairman, I'd like, if I might, to have the correspondence between the committee and Mr. Seidman and the committee and Secretary Brady included in the record. I think that it's giving us a pattern.

The CHAIRMAN. Without objection, so ordered.

[Information supplied for the record follows:]

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

June 8, 1989

The Honorable L. William Seidman
Chairman
Federal Deposit Insurance Corporation
Washington, D.C. 20429

Dear Mr. Seidman:

As we move into the final stages of the S&L legislative process, there are a couple of issues on which I would like your comments. One issue concerns the size of the RTC's funding needs. With the recent release of the new FDIC loss estimate for thrifts now in conservatorship, you said the "report indicates that the Administration's program is based on realistic loss estimates." However, when the new data are considered along with figures you presented in March 8 testimony to the House Financial Institutions Subcommittee, a different conclusion suggests itself.

In the attached table, you showed two sets of cost estimates, which differ in their assumptions about losses from book values on home mortgages and mortgage securities. Excluding the cost of the 1988 deals (top line) from both columns leaves estimates of $53 and $69 billion, respectively, as the cost of resolutions to be handled by RTC.

Your recent loss estimates imply that these numbers are probably too low. The March estimates for the 217 RAP insolvent and unprofitable thrifts were $23 and $25 billion. The Mid-May estimate for 212 RAP insolvent institutions in conservatorship, made after more careful examination, was $30 billion. It seems reasonable to assume that errors on the March estimates for other categories were proportional. Thus if the $25 billion estimate of RAP insolvent losses should have been 20 percent higher, we should raise the $69 billion "Est. Cost #2" by 20 percent to $82 billion. The comparable #1 estimate would be $70 billion.

Even these higher numbers may overstate the adequacy of the $50 billion available to the RTC in the legislation. These cost estimates are present values, but the $50 billion will not be available immediately; it will flow in over a 3-year period. On average, the money will be spent at least a year from now, maybe longer. In the meantime losses will continue to build up. Adding 10 percent to allow for the accumulation of losses produces a alternative estimates for the needs of the RTC (ignoring liquidity problems) of $76 and $90 billion.

Viewed in this light, aren't your new loss estimates more consistent with a funding plan for RTC that provides $75 or $100 billion than with the $50 billion plan in the current legislation? Perhaps you have reevaluated prospective losses at RAP-solvent thrifts since March. If not, how do you resolve the apparent inconsistency? If $50 billion likely is not going to be enough, perhaps we should do something about it now. I look forward to receiving your comments on this.

June 8, 1989
page 2

Another concern of mine is the interest rate risk at conservatorships. As I understand it, large maturity mismatches are common at thrifts under the FDIC's control. While market yields may continue to decline and, therefore, to reduce the cost of resolutions, the alternative is also quite possible. To help us assess the dangers, I would greatly appreciate some statistical information on interest rate risk at FDIC conservatorships. Using March 31 data, what are the aggregate amounts of assets and liabilities whose yields reprice within 1 year and within 3 years? Please quantify, with at least an estimate, the effect of FDIC actions since then? I would also appreciate knowing whether you share my concern. If you do, couldn't the risk be reduced with interest rate swaps or other market hedges?

These issues are both very complicated and deserve thorough examination. Unfortunately time is very short. I would be appreciate your response within 2 weeks.

Sincerely,

Donald W. Riegle

Donald W. Reigle, Jr.
Chairman

CHART A

3rd QUARTER SUMMARY SHEET DATA ON FINANCIAL TROUBLED S&Ls ($BILLIONS)

S&L Group	NO.	Total Assets	Total Liab.	Annual Income	Est. Cost #1	Cost To Assets	Est. Cost #2	Cost To Assets
Handled by FSLIC in 1988	208	$103.2	$120.1	$-10.2	$38.9	.38	$42.9	.42
Other:								
RAP - Insolvent & Unprofitable	217	$56.9	$65.6	$-5.3	$22.8	.40	$25.0	.44
RAP - Insolvent & Profitable	5	$2.5	$2.5	$0.0	$0.4	.16	0.6	.24
SUBTOTAL	430	$162.6	$188.2	$-15.5	$62.1	.38	$67.9	.42
RAP Solvent but GAAP - insolvent & unprofitable	72	$24.2	$23.7	$-0.3	$3.6	.15	$4.8	.20
RAP - Solvent but GAAP - insolvent & profitable	45	$12.1	$11.7	$0.3	$1.6	.13	$2.2	.18
SUBTOTAL	547	$198.9	$223.6	$-15.5	$67.3	.34	$74.9	.38
RAP & GAAP - solvent but tangible insolvent and unprofitable	69	$55.1	$53.2	$-0.5	$8.3	.15	$10.9	.20
RAP & GAAP solvent but tangible - insolvent and profitable	52	$66.4	$63.5	$0.2	$6.8	.10	$10.9	.16
SUBTOTAL	668	320.4	$340.3	$-15.8	$82.4	.26	$96.7	.30
Marginally solvent but unprofitable	154	$101.1	97.6	$-0.7	$9.6	.09	$14.9	.15
TOTAL	8~~8~~2 2	$421.5	$437.9	$-16.5	$92.00	.22	$111.6	.26

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[1] Estimated Cost #1 :Failed-bank cost formula with zero loss assigned to residential mortgages and pass-through securities.

[2] Estimated Cost #2 :Failed -bank cost formula with 10% loss assigned to residential mortgages and mortgage pass-through securities.

FEDERAL DEPOSIT INSURANCE CORPORATION Washington DC 20429

OFFICE OF THE CHAIRMAN

June 26, 1989

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to respond to your June 8th letter in which you expressed concern regarding the RTC's funding needs and the level of interest rate risk in the institutions under conservatorship.

The FDIC has estimated that RTC may have to deal with S&Ls holding $300 to $500 billion in assets. This assumes that RTC would be responsible for old FSLIC and the transactions previously arranged by FSLIC that require ongoing support. (FDIC has advocated the placement of old FSLIC into RTC, but that is not the structure in either bill.) Such transactions involve about $130 billion in thrift assets, half of which are protected under yield maintenance arrangements. The $50 billion funding however, is not earmarked for prior transactions but for new case resolutions.

No one can predict with certainty whether $50 billion is enough to cover the losses at the S&Ls likely to need resolution over the next three year, since costs depend on predicting the future; e.g., economic conditions, interest rates, and property values. At this time, we believe $50 billion is a reasonable estimate upon which to base legislation.

Another factor in determining how much money will be needed is the number and size of S&Ls going to RTC for resolution. RTC handles failures only during the first three years; failures after that would be handled by SAIF. The earlier FDIC table you referred to provided estimates of the cost of failure of all S&Ls with no tangible capital -- including profitable ones -- as well as unprofitable S&Ls with less than three percent tangible capital. It is not likely that all of these S&Ls will fail in three years, and some may recover and survive. Thus, it is difficult to project exactly how many S&Ls the RTC will have to handle.

For your information, we have enclosed the latest results of our model which used fourth quarter data to estimate losses for 428 S&Ls that appear most likely to go to RTC. These include all RAP-insolvent, GAAP-insolvent, and unprofitable tangible-insolvent S&Ls. The model suggests these S&Ls with assets of $180 billion could be handled for $44 billion. Note the loss rate for the RAP insolvent and unprofitable S&Ls averaged 37 percent of assets. This appears reasonably in line with the $30 billion or 40 percent loss rate indicated by our on-site reviews of the RAP insolvent and unprofitable S&Ls under conservatorship.

Based on our on-site reviews completed thus far, it appears that $50 billion will be enough, though there does not appear to be much of a comfort margin.

The rate at which funding will be necessary is also difficult to predict. It depends on how quickly institution problems can be resolved. We believe your bill makes a reasonable estimate of resolution needs.

While $50 billion appears to be a reasonable estimate of ultimate cost, we want to point out that RTC likely will need considerably more than $50 billion to provide working capital to effect resolutions. To explain, the S&Ls on the enclosed list are funded by about $180 billion in deposits and borrowings, but about half of their assets are either troubled or non-traditional thrift assets. In an ideal world, RTC would find buyers willing to assume all liabilities in return for $50 billion plus all the failed thrifts' assets. That simply is not going to happen. Interested S&L buyers we have talked with thus far have been reluctant to accept anything but traditional assets and cash.

Moreover, depositors may claim their insured deposits at any time, and RTC must have the cash to meet those demands. For some S&Ls, the only viable option will be to pay off all depositors and liquidate the assets. Thus, the RTC will need access to enough funds to satisfy S&L depositors and other liabilities while assets are being liquidated.

RTC must have the ability to raise cash or provide cash-equivalent obligations To meet these demands, we believe the RTC should be able to issue obligations with the backing of the full faith and credit of the U.S. government. The amount of such federal guarantees should be limited by placing restrictions upon the RTC similar to those the proposed legislation would place on the FDIC. Thus, this limitation would restrict RTC's authority to issue obligations by providing that RTC must have resources available to repay those obligations without further appropriations.

Finally, we share your concern about the interest-rate exposure of S&Ls under FDIC supervision. Substantial exposure does exist. For S&Ls in conservatorship as of April 15, year-end 1988 data indicate that liabilities repricing within one year were about $64 billion, compared with repricing assets of $25 billion. Liabilities repricing within three years were $75 billion, compared with assets of $30 billion. Our policy is to reduce exposed positions as soon as possible; but under current conditions, funding remains short-term, while most assets remain long-term.

Some of the S&Ls have engaged in hedging strategies, and we have encouraged this effort where appropriate. Our present belief is that the expense of hedging may not be justified in many situations. We will continue to monitor rate risk, with a view to reducing interest rate exposure.

Do not hesitate to call if you should want to discuss these issues further.

Sincerely,

L. Wm Seidman

L. William Seidman
Chairman

Enclosure

YEAR-END 1988 COST ESTIMATES FOR INSOLVENT S&Ls
TEN PERCENT LOSS ASSUMPTION ON RESIDENTIAL MORTGAGES AND MBSs
($ BILLIONS)

	S&L Group	Number	Gross Assets[1]	Annual Liabilities	Annual Income	Cost Estimate	Cost to Assets
(1)	RAP Insolvent & Unprofitable	232	$75.1	$79.6	$-7.0	$27.7	.37
(2)	RAP Insolvent & Profitable	5	4.3	4.2	--	0.7	.16
(3)	Total RAP Insolvent (1+2)	237	79.4	83.8	-7.0	28.4	.36
(4)	Other GAAP Insolvent & Unprofitable	91	32.4	30.9	-0.5	5.3	.16
(5)	Other GAAP Insolvent & Profitable	36	10.0	9.5	--	1.6	.16
(6)	Total Other GAAP Insolvent (4+5)	127	42.4	40.4	-0.5	6.9	.16
(7)	Total GAAP Insolvent (3+6)	364	121.8	124.2	-7.5	35.3	.29
(8)	RAP + GAAP > 0 Tangible Insolvent & Unprofitable[2]	64	58.1	54.0	-0.6	8.7	.15
(9)	Total RAP + GAAP Insolvent + Tangible Insolvent and Unprofitable (7 + 8)	428	179.9	178.2	-8.1	44.0	.24

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[1] Gross assets include general and specific valuation allowances, loans in process, deferred loan fees and valuation allowances for mortgages held for sale.

[2] Tangible net worth is defined as GAAP capital minus all intangible assets other than mortgage servicing rights.

May 25, 1989

The Honorable Nicholas Brady
Secretary
Department of the Treasury
Washington, D.C.

Dear Mr. Secretary:

The thrift industry legislation that has passed in the Senate and is now working its way through the House will go far toward resolving the current crisis and preventing a similar future debacle. Your leadership on this issue has been of critical importance, and I deeply appreciate the close and cooperative working relationship we have established.

As the Administration's point man on this issue, I want to raise with you a growing concern I have as we move toward final enactment of the legislation.

That issue concerns the overall estimated cost of the rescue package and whether the $50 billion being sought by the Administration will really be adequate to deal with the problem.

I have a growing concern, shared by many colleagues here, that new evidence is indicating that the resolution cost may well exceed the $50 billion estimate by a substantial amount.

A report released last week by the FDIC estimates the losses at 212 insolvent thrifts with $73 billion in assets to be $30 billion. There are roughly another 500 institutions with $250 billion of assets that, in 1988, were insolvent or unprofitable or both. While losses at these thrifts will likely be smaller in proportion to assets than those the FDIC has examined, high interest rates, customer withdrawals and other factors are pushing more and more S&Ls toward insolvency.

This concern was sharpened last week when Assistant Secretary Mullins said of the $50 billion available to RTC: "We will not need it [all]." Yet the release of the FDIC estimates a day later have cast doubt on these optimistic predictions, and Chairman Seidman was blunt in saying: "If things get worse and a lot more [associations] go insolvent, it certainly won't be enough." Some doubt whether there is enough money even for those thrifts that are already insolvent.

It is fair to say, I think, that if the American people find that substantially more money is needed from them to resolve the S&L problem within the next one to three years, they will be disillusioned and angry -- and with justification. A failure of judgment in this area would reflect poorly on everyone involved in this rescue effort.

Let me therefore suggest the following two steps.

First, I would ask the Treasury Department to take a fresh, updated look at the potential financial exposure here and see if any recent information requires an upward adjustment of the estimated resolution cost. If you were to decide that we should make an upward adjustment in the amount needed, I would undertake to achieve that higher amount in the current legislation.

Second, if the Administration still believes the $50 billion figure to be fully adequate, then I would ask for an indication of what contingency approach would be used, if the estimates prove wrong, and the amount needed were to rise to:

a) $75 billion
b) $100 billion
c) $125 billion.

As you and I have discussed many times, it is essential that this legislative package work effectively -- once enacted and implemented -- and this letter is written in that spirit.

Thank you for considering this request and I look forward to your formal reply within the next two weeks.

Sincerely,

Donald W. Riegle, Jr.
Chairman

THE SECRETARY OF THE TREASURY
WASHINGTON

June 23, 1989

The Honorable Donald W. Riegle, Jr.
United States Senate
Washington, DC 20510

Dear Don:

Thank you for your letter, dated May 25, 1989, concerning the thrift legislation. We appreciate your active leadership on the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

Your letter states the concern that the legislation may not provide sufficient funds to deal with the problem. The Administration's plan calls for $50 billion for case resolutions by the Resolution Trust Corporation (RTC) for thrifts that have been or will be placed in conservatorships or receiverships from January 1, 1989 until three years after the date of enactment. During this period, a $5 billion emergency line of credit from the Treasury will also be available. From October 1991 through 1999, the plan provides an additional $24 billion for case resolutions as well as $8 billion to capitalize the Savings Association Insurance Fund (SAIF). We believe -- as does the Federal Deposit Insurance Corporation (FDIC), General Accounting Office and the Federal Reserve -- that these resources are adequate to do the job.

When the Senate Banking Committee thoroughly examined this issue, both in hearings and at the staff level, the numbers underlying our conclusions and the assumptions that were used were explained in detail. This appeared to satisfy the Committee's concerns at the time, since no amendments were offered to increase the amount of funds for case resolutions and the bill passed by a unanimous vote.

We, too, are familiar with the information contained in a recent FDIC report which you suggest might indicate that the resolution costs for RTC cases over the next three years may exceed $50 billion by a substantial amount. The FDIC's report contains an estimate, based on its on-site examination, of $29.8 billion in losses at 212 thrifts that are currently in receiverships or conservatorships. But, when he released that report, FDIC Chairman Seidman said that "this level of loss is consistent with the Bush Administration's estimate of losses in all insolvent institutions to be handled by the Resolution Trust Corporation."

It is also my understanding that the General Accounting Office, in recent discussions with Banking Committee staff and others, declined to conclude that the amounts provided for under the Administration plan are inadequate.

Finally, our most recent reexamination of thrift data supports our earlier conclusion that $50 billion for RTC cases over the next three years is sufficient.

Based on this broad consensus, I continue to believe that the resources provided by the Administration's plan are adequate. Let me emphasize, however, that this level of resources, no matter how thoroughly researched or widely agreed upon, is still based only on estimates. Uncertainties include the level of interest rates, the strength of the economy, as well as many other factors that could have a significant impact on the size of the problem. As a result, the actual cost of case resolutions could be higher or lower, depending on the actual circumstances. In summary, we feel the resources provided for in the Administration's plan and in both the Senate and the House bills are reasonable given these uncertainties.

Your letter also asks what contingency approach would be used if the size of the problem exceeds $50 billion. As I mentioned above, the RTC has a $5 billion line of credit from the Treasury -- and as a practical matter it is doubtful that the RTC could efficiently spend more than $55 billion on resolution costs on RTC cases over the next three years. Furthermore, under both the Administration plan and the Senate bill, $24 billion will be available for thrifts that fail three years from the date of enactment, and this would not affect the build-up of $8 billion to capitalize SAIF by 1999. Finally, the legislation specifically provides the FDIC authority to raise premiums to handle additional cases in the event of extraordinary circumstances.

While we believe these resources are sufficient for all reasonable contingencies, your letter also asks what would happen if the resources were exhausted. In that event, it would be necessary for Congress to revisit the issue. I believe this is appropriate: if circumstances were to change so dramatically, Congress should indeed take a second look. In fact, the Senate Banking Committee took the same view when it voted at the end of the mark-up of S.774 to cap the ability of SAIF to spend more than $24 billion from 1991 to 1999 without receiving permission from Congress. If your view has changed, however, and you want to ensure that additional contingency resources are available without returning to Congress, the conferees could of course decide to increase RTC's contingency line of credit.

Let me mention one related point, which concerns the House bill's cap on the authority of the RTC to issue notes and guarantees for working capital purposes. I understand the Congressional concern to impose such a cap, particularly in view of last year's experience with FSLIC, where notes and guarantees were issued on the questionable strength of future premium income. I have no objection to a cap that would prevent the RTC from taking similar actions. However, the cap imposed by the House bill is far more restrictive and could create the following anomalous result: the RTC would be forced to seek more funds simply for working capital purposes from Congress as early as next year, even though it would own substantial amounts of real estate and other tangible assets.

A cap that prevents borrowing on the strength of tangible assets owned -- even though the taxpayer would not be at risk -- is likely to force Congress to revisit this whole issue prematurely. I urge you to consider this matter very carefully as we approach the conference between the Senate and the House of Representatives. We would be happy to work with you to design a cap that would avoid unintended consequences.

In summary, I continue to believe that, in the absence of strong evidence to the contrary, an appropriate level of resources is included in the Administration's plan, as embodied in the Senate bill.

I look forward to working with you in the conference to produce a strong, bipartisan bill that maintains the essential provisions of the Administration plan.

Sincerely,

Nick

~~Nicholas F. Brady~~

Senator **Wirth**. I mean, I know you're doing the best you can but I—you know, here we are in this situation and it seems to get fuzzier and fuzzier, this number, as it gets bigger and bigger. And, you know, it's obviously of great concern to our constituents and to each of us and, you know, what do we do to get a better handle on this; do you need more people to help you do the job or——

I understand we can't predict exactly what's going to happen in the real estate area, but to miss by a factor of 2½ times—you know, if Darman missed by 2½ times in his estimates, you know, that would be cause for rapid removal, I would think.

Senator **Sanford**. He'd be dead. [Laughter.]

Chairman **Seidman**. Well I'm not going to comment on Mr. Darman, but I would just point out on our estimates from the beginning we have indicated to the committee and to the chairman that there was no real way to come up with an estimate until we had been on-site in these institutions, that these were the best estimates we could make based on the information we had. And that was some time ago.

I had said for a considerable period of time that the $50 billion was not going to be enough and I didn't put a number on it because I wanted to get through with the on-site observations.

Senator **Wirth**. Mr. Seidman, welcome back. Thank you very much.

Chairman **Seidman**. Thank you.

The **Chairman**. Senator Heinz, did you have an opening comment before we went to Senator Bond?

Senator **Heinz**. I would just ask that it be put in the record, Mr. Chairman.

The **Chairman**. Very good. Without objection, so ordered.

STATEMENT OF SENATOR JOHN HEINZ

Senator **Heinz**. Mr. Chairman, I join you in welcoming Bill Siedman and Bob Clarke to our committee as we continue our hearings on deposit insurance reform and the competitiveness of our financial services industry. I'm not ordinarily superstitious, but with the deposit insurance fund at very low levels and real estate losses at national banks at fairly high levels, scheduling these witnesses for our 13th hearing on financial modernization may be provoking lady luck.

Of course, when it comes to protecting the taxpayer from potential losses from the deposit insurance system we cannot rely on luck. We need to rewrite the rules of a game where all the winnings go to the shareholders and the losses go to Uncle Sam. Too many in the S&L industry played a crooked game that ultimately broke the house.

At the same time, international competitors are playing by new rules in global markets. It is hard for our financial service firms to compete when they are not playing with a full deck. However, we must ensure that our firms that take risks in new areas are gambling with their own funds.

Mr. Chairman, these are tough issues. I hope today's witnesses have a few aces up their sleeves.

The **Chairman**. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

And before returning to the subject which you discussed in your testimony today, let me continue down the path of the digressions which we've followed:

The ranking member and you had a very important discussion of some of the historical factors and perspectives on the savings and loan crisis and obviously from the questions today there is a good deal of confusion that has come up around this whole subject.

You may be aware that last week Senator Dodd and I and a number of other members of this committee introduced legislation to set up a nongovernmental independent blue ribbon bipartisan commission to give the American people and the Congress a report, a candid evaluation of the various factors: State and Federal regulation, supervision, capital standards, deposit insurance, macroeconomic changes, regional recessions, fraud and abuse that may have led to this crisis.

I would be interested in your evaluation of whether a report, say, done in 6 months or so could provide any useful information to the American people and also to those of us considering reform of deposit insurance and financial modernization as we move into the next session of Congress.

Chairman SEIDMAN. Well certainly a commission like that, Mr. Bond, could provide useful information; I think there's no doubt about that. I have some concerns about whether, in the current atmosphere, you can get a de-politicized report given the environment that we're now in.

If there is a way to do that, I think it can certainly provide us with some valuable information. My concern would be that it would simply be shifting the political battle to yet another forum.

Senator BOND. Well I think it's very important that we get out of the political warfare and if you have some ideas on how we can better get the discussion on an objective basis we would welcome those because much of what I've heard recently has not been very useful and is often best described by the barnyard vernacular.

Chairman SEIDMAN. I'd be pleased to submit some ideas to you.

Senator BOND. Recently I was visiting with a representative of a foreign central bank talking about the competitiveness of our banks and he smiled and told me that the most, just, impossible and unfathomable restrictions that we put on our banks are those contained in the McFadden Act and the Douglas amendment.

You refer briefly to that in your oral statement and you have a much more lengthy description on pages 16 and 17 of your submitted testimony and I would appreciate hearing a summary of your views for the record on that particular point.

Chairman SEIDMAN. Well my view is that we ought to allow banks to be national institutions and to have as a base for their operations the entire country in the same way we do supermarkets. Safeway doesn't have any restrictions; whatever State they operate in, they operate under the rules of that State. And I think banking, in order to have the proper base, needs to have the same kind of a system as other institutions do in the country.

Senator BOND. And you don't feel that would interfere with the regulation, either by States or——

Chairman **Seidman**. I think it can be—I think it clearly can be worked out and that's why I said the type of structure that you're going to set up to regulate will depend on whether you move in that direction or not but I believe it clearly is susceptible of regulation and I think it will provide, among other things, a very great addition to stability.

I would just point out to you that the State of Arizona—where I headed a commission on interstate banking—opened the State to interstate banking; and as a result of which most of the banks in the State were purchased by out-of-State banks. As a result of which they haven't had the series of failures that Texas had, even though their market is worse than the Texas market. And the reason is, of course, they're part of national institutions.

So I think there is both an argument based on stability and achieving a basis that will make them truly U.S. banks in world competition.

Senator **Bond**. Lately many of us on the committee have been hearing complaints from bankers expressed with a great deal of warmth and enthusiasm about the regulatory burden that we, in Congress, have imposed upon them, particularly consumer laws, the Home Equity Loan Disclosure Act, changes to the Home Mortgage Disclosure Act, the CRA rating disclosure and those things.

I would appreciate your view on whether these complaints are justified or whether these regulations are merely the price that banks pay for the Government backing for their liabilities and, alternatively, is there a better way that we could meet these worthwhile goals without imposing the kinds of burdens we do impose on banks?

Chairman **Seidman**. Well I think in general they are placing a burden on banks but particularly on small banks. And I think to a substantial extent they have not proven to be of great use with small banks. I think the burden with big banks—while there is a burden, most of them can handle it much more easily.

And I'm not sure that we should be treating all banks in the same way when it comes to the kinds of burdens that CRA puts on the banking system. And this may be true in other areas.

You know, we have continuously said a bank is a bank, whether it's $200 billion or $100 million. And there's a great difference. And I think for the smaller banks this is a very material burden that we should look for ways to reduce.

Senator **Bond**. Any cutoff, any arbitrary cutoff that you would say the economies of scale would permit the more efficient implementation of these requirements?

Chairman **Seidman**. No, I don't have a number that I can give you but if you take a billion dollars as the cutoff, why you'd be handling, you know, 90-some percent of the banks. So it wouldn't have to be very high before you could relieve a lot of the institutions of some of the kinds of burdens that we've been placing on them.

And I think it's very important that we try to help and maintain as many independent small banks as we can within the system. I think the decentralized system has produced some very good things for our banking system. And I do think CRA, particularly for small banks, is a burden that is large enough to be examined in terms of their overall viability.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. Very good. Thank you, Senator Bond.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, I want to begin with a quotation of an individual who occupied the same position that Mr. Seidman does for FSLIC before this committee just 26 months ago. When I finish, this will lead to two lines of questioning.

Mr. Danny Wall in May 1988 made this statement when asked "Do you believe that we can avoid a taxpayer bail-out of the savings and loan industry?"

> We believe that the numbers are such right now that, barring any significant shift in our assumptions of the economy, generally we are within striking distance of having dealt with all the problems with the resources available.
>
> Now I am not a Pollyanna to say that absolutely without question, but we are clearly within range and it is clearly appropriate for the Congress and for the industry to give us the time to utilize those resources and for the next President and the next Congress to look over our shoulder into our closets as to what success we have had and what problems remain, if any.

That statement rings in my mind when I see statements such as the one you made, Mr. Seidman, a couple of weeks ago relative to the status of FDIC.

And the question I asked of Mr. Wall on that day and I would ask of you today in light of your understanding of the condition of FDIC: is there any action that you would recommend that Congress should take between now and the conclusion of this session of Congress in order to give the American public the necessary confidence in the stability of the FDIC fund?

Chairman SEIDMAN. Well I think you've already taken the action you need in that you have officially pledged to support the insured deposits in banks as a result of FIRREA and you have given us the power to increase premiums on banks if we believe it necessary, so I think we have the tools in place.

I would just say, with respect to Mr. Wall's statement, as you probably are aware, I did not agree with him at that time, did not agree with that statement, and I don't think that my statement was really comparable. I didn't say that it's clear that we have the power to straighten this all out; all I said is at this point with the banks that we can actually count and see failing, we believe we have the resources to handle them. But that still will put us in a very much stressed position and we are going to have to work our way out of that and that will depend what conditions bring.

Senator GRAHAM. In answer to the question, to clarify: there is no action that you recommend that Congress take between today and the date that we adjourn for the conclusion of the 101st Congress relative to the FDIC fund?

Chairman SEIDMAN. No, I don't think there's anything that I would recommend at this time. We will be monitoring it; there may be something in the future.

Senator GRAHAM. Thank you.

The second line of questioning goes to the point that you alluded to and that is the accuracy of Mr. Wall's statement.

Mr. Wall, in May 1988, stated that resources were available within the FSLIC fund to deal with the extent of the problems. Less than a year later, the President was asking for $55 billion for a 3-year taxpayer contribution.

What do you think happened between May 1988 and the spring of 1989 that caused a zero problem to become a $55 billion over 3 year problem?

Chairman **Seidman**. What happened is we recognized the problem that was already there.

Senator **Graham**. Why do you think that we didn't recognize the problem in May 1988?

Chairman **Seidman**. I have no way of knowing that. That was done by a different agency. And I had obviously stated at that time, somewhat reluctantly, that I thought the problem was much larger than was being stated and I don't know why they didn't agree.

Senator **Graham**. So you think the problem in May 1988 was not an economic problem but was an inability to see or, if to see, to clearly state the problem?

Chairman **Seidman**. I don't know why—I know what our numbers showed but they had far more access to information than I had and therefore they had to exercise their judgment based on all the facts they knew. And I assume they did that and it simply turned out that conditions were much worse than apparently they recognized.

Senator **Graham**. Coming forward to the spring of 1989, one of the recommendations of the administration was that that $55 billion be funded off-budget, through the REFCORP bonds. In the final compromise legislation, $30 billion was placed off-budget and $20 billion on-budget. At the present time, of that $30 billion that was off-budget, approximately $10 to $12 billion remains unspent.

Do you believe that we ought to, (a) put that $10 to $12 billion of unspent off-budget authorization on-budget and, (b) any additional funds such as the $100 billion that was suggested yesterday, should that be on-budget or off-budget?

Chairman **Seidman**. With respect to the REFCORP remaining amounts, I really have not been in on that, that's done by Treasury and I really am not in a position to express an opinion because I haven't studied that.

With respect to the future, I think that all funding for losses should be on-budget. The funding to provide us with working capital, I think, distorts the budget because it is really a fund that we borrow against security, the assets that were taken over, for a short time. If you put that on-budget you will get some very wide swings in revenues and expenditures that may be misleading and I would prefer to see the working capital treated as a separate off-budget item.

Senator **Graham**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Graham.

Senator **Mack**. Thank you, Mr. Chairman.

I want to follow up on the FIRREA cost that we've talked about just to make sure I've got this right. I didn't have an opportunity to read all through your testimony of yesterday but I got the impression that while you're talking about a new figure, $100 billion, for this next year and maybe into 1992, as I gather, that the total cost of the operation has not been increased but this is your moving forward working capital requirements, is that right?

Chairman **Seidman**. That is correct. The estimates that I made yesterday were based on the losses that Secretary Brady had put before the Congress in his $90 to $130 billion. And what we really were saying is that out of the $90 to $130 billion, it looks like we're going to need at least $100 billion.

Senator **Mack**. OK.

This is primarily working capital that you're talking about?

Chairman **Seidman**. The increased amount was the working capital because the RTC is up and running and it's moving now quite rapidly to resolve institutions and every time we resolve an institution we need more funds to pay off the depositors, take the assets and then sell the assets. So there really was no change in the overall loss estimates in what I said yesterday.

Senator **Mack**. So what has happened is the acquiring of institutions, because the RTC is up and running, is moving along quite well, as most of our colleagues have been kind of screaming about for the last several months, and I assume though that the reason for the additional funds also is because the real estate market has not allowed you to sell many of the assets that you would like to have been able to sell?

Chairman **Seidman**. Yes, that is correct.

So that really the speed-up in handling the situation has required the funds faster.

Senator **Mack**. OK. I just want to raise one question with respect to your comments this morning about reforming of the system:

On page 3 of your testimony, the last sentence says:

> . . . a reformed financial system first, a regulatory structure to fit that new system second.

I bring that up in the sense that a couple of times this morning the whole issue of—and I guess this is really more from a political perception, but let's face it, there are people who are very sensitive today, all of us, about what the perceptions are that the Congress made—the perception is that the Congress made major mistakes in the 1970's and the early 1980's with respect to this issue, that the S&L's were in trouble then, there would be people who would claim in retrospect that we could look back and say that the banking industry is in trouble today, you know, reading through:

> Insurance fund under stress, lowest in history, thousand problem banks, could have loss in the current year.

You know, it sets up the whole kind of scenario and you guys are getting ready to talk about deregulating the banking industry.

It seems to me one of the things that I look back at, that when you deregulate, if I were the insurer, I would want to, at the same time, have an increase in regulation and a regulatory structure to fit the new system immediately at the same time; in fact, I would make the argument that you really need to have in place the regulatory system even before the reform because you have to have people on board who are going to understand the very intricate financial deals that are going to take place as a result of this expanded power.

So I'm just sensitive to that and would like for you to expand on it, if you would.

Chairman SEIDMAN. Well I would like to comment on that because I think maybe the way I said it didn't make it clear:

I think they both ought to be done at once, but that you can't decide what regulatory restructure you want to do until you know what kind of a banking system you're going to have.

So what I'm saying is all these other suggestions I made and others have made—we need to decide are we going to have a thrift industry, are we going to go for separate entities and restrict where funds go, what are the ways that we are going to change our system—when we know what kind of a system we have, then we can set up a regulatory structure to deal with that kind of a system. It makes a lot of difference if you're going to go to national branching and things like that.

Senator MACK. Would you consider that there ought to be a transition period then maybe?

Again, one of the concerns that I have is—go back to the S&L thing for a moment. When they were told, whether it was—by a State legislature that you can do anything that you want to assume that the—even forgetting the number of examiners that were out there, let's just assume the number didn't decrease, let's just say they remained the same—their ability to dig into the details of that financial transaction I don't believe could possibly be at the same level as the people who are making those deals.

And what I'm saying is that maybe we ought to consider some kind of transition period, so that those who are going to do the examinations have in fact got the tools and the capability on the same level of those who are making the decisions about what kind of transactions to become involved in.

Chairman SEIDMAN. Well I completely agree with that and it was very clear in the S&L industry that the changes were made in substance but nobody then looked at the regulatory structure to see if there was one that could deal with it; if they'd looked, they'd have seen that there wasn't one.

And when Mr. Gray, who was responsible, finally did see that there wasn't one, he didn't get the response he needed to try to put it in place.

Senator MACK. That's why I think it might be helpful to get it done up front.

Chairman SEIDMAN. Well I agree with that. I want to make clear that I'm not saying change the substance and then think about it, I'm simply saying that when we know what kind of a system we have then we can better judge how we want to change the regulatory system.

Senator MACK. I had a pretty good idea that that's what you meant, but I thought it was important that you have an opportunity to underscore——

Chairman SEIDMAN. I appreciate your making that—bringing that out.

Senator MACK. OK.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me just say, Senator Mack, that I agree with you on that and I would not be of a mind to report a bill out of here that did not anticipate those new regulatory requirements and create a transition period, so that we had a regulatory capability established, up and running, and keyed-off—because, as I think you importantly said, whatever the new scope of business is, I mean, we don't—until we decide that question, you can't really fully understand what the nature of your regulatory apparatus needs to be.

But there's absolutely no reason to get trapped off base without having a competent and wisely designed regulatory structure out there before any new rules take effect and I think that has to be part of anything we do.

Senator **Mack**. Thank you, Mr. Chairman.

The **Chairman**. Senator Dixon.

Senator **Dixon**. Chairman Seidman, nice to see you again this morning. I appreciate your continued good contributions to our attempt to solve these problems.

I was interested in your testimony on page 6 where you go into this whole problem of supervision and you say:

> Most unfortunately, however, little attention was paid to supervising the exercise of the expanded powers. The results are well known. A number of S&L's went on the institutional equivalent of a bender, and the Nation will be paying the tab . . ., and so forth.
>
> There were, of course, additional factors that contributed to the S&L debacle. One among them was that the Federal S&L supervisor, the Federal Home Loan Bank Board, was not just a policeman . . ., and so forth.

You mentioned Mr. Gray. And I think your comments reflected the fact that you believe that he was trying to do an effective job and didn't get the tools to do it.

And I wanted to call your attention to the book Inside Job by Stephen Pizzo; have you read that book—or have you read these excerpts from it that I'm about to refer to?

Chairman **Seidman**. Yes. I have that, yes.

Senator **Dixon**. On page 268 it refers to the fact—and I quote directly:

> Gray laid his cards on the table. He wanted to double the examination staff to 1,400. He needed to raise examiners' base pay from an average of $14,000 a year to a level more competitive with private industry examiners.

And that reflects, if I may say publicly, the nature of our private talks, exactly what you've told me: there weren't enough examiners and they weren't paying them adequately to do a good job if they had enough.

And I regret to say that the conclusion here is that Ms. Horner denied him that request and in effect I think ultimately said if Mr. Gray would shut up he could have an additional 39 examiners.

And isn't that the central part of everything you've said here to all of us on a bipartisan basis—my friend, the distinguished ranking member, who asked you some questions about the effect of legislation: If there had been adequate regulators and examiners and supervisors in the field adequately paid to do a job it would have made a difference in respect to what has occurred here. Is that true?

Chairman **Seidman**. I'm sure that's true.

Senator **Dixon**. Now looking at it for the future—and it's a visit you and I have had in the past on several occasions—I ask you now publicly: are we doing enough in your view now to address this problem for the future? Is the regulatory system in place in your view now both in respect to thrifts and banks; do we have enough in the field and are we paying them adequately to do a first class 100 percent supervising job to protect the American taxpayer?

Chairman **SEIDMAN**. I don't think we're there yet but we are moving in that direction. We are increasing the supervisory group, we are allowed to pay them on a competitive basis, thanks to some of the things that the Congress has done, and so I think we will have that force in place—we're still building it up—and we do have the resources to do that.

Senator **DIXON**. Now you also say in here—if I may, one more time refer to some of your testimony—on page 27, where you're talking about deposit insurance. And you talk there on that page—I won't read it all—about the question that I've advanced on numerous occasions as you know about risk-based deposit insurance and you point out in the end the Government is the final insurer.

But I would put it to you again that I think it would help the system to have a risk-based deposit insurance equivalent for part, an incremental part, of the insurance system to set the base rates and things like that. And I wonder whether you think that has some value?

Chairman **SEIDMAN**. I gather your suggestion that we have a separate risk-based—based on private sector insurers——

Senator **DIXON**. For a percentage of it——

Chairman **SEIDMAN**. For a percentage——

Senator **DIXON** [continuing]. That will set the number of base——

Chairman **SEIDMAN**. I think that that is something that ought to be explored. We have, to some extent, talked with insurers about that and we haven't found a lot of real interest, but of course that would depend on what the actual deal was.

But if it could be put in place, it would clearly give us a better handle on evaluating risk because it would be done by the private sector. But it will not relieve us from having the Government as the ultimate insurer in the end.

Senator **DIXON**. I agree with that.

Now piggy-backing that, are there more things we should be doing about the power of the FDIC and those involved in the deposit insurance system to make judgment calls on charters and questions of that kind? I thought I heard you say that earlier.

And I wonder whether you could make available to some of us on this committee the language you think ought to be employed. Because I agree with you that the insurance system ought to have something to say about the people it's insuring out there, the institutions. Is there more that should be done there?

Chairman **SEIDMAN**. Well I think that as a basic principle. The insurer should decide——

Senator **DIXON**. So do I.

Chairman **SEIDMAN** [continuing]. Which institutions it insures and that is the ultimate protection that ought to be afforded the taxpayer. So we have that now with the S&L's. We don't have that with the banks.

I will repeat that Mr. Clarke—that clearly has not been a problem——

Senator Dixon. Yes.

Chairman Seidman [continuing]. But I think, as a matter of principle, the insurer should decide what institutions qualify for insurance. And clearly if we had that on the S&L side and that had been enforced, it would have made a tremendous difference, just as the Bush task force recommendation would have made a tremendous difference in which they recommended that if an S&L went into other businesses it automatically transferred to the other insurance fund and became insured and went under banking rules. So——

Senator Dixon. I'd like to have my staff talk to your staff about the kind of language that ought to be employed. And I thank you.

And since the light is about to turn red, two more quick questions:

I ask you again in public, as I've asked Chairman Greenspan and others—and you and I have talked about it in private—do you think we ought to do anything about the $100,000 deposit insurance at the level it is now? My sense of it is all of you are saying by now we probably ought not do anything to change that. Now I'm asking you again in a public place.

Chairman Seidman. I don't think it's an important change to make in terms of reducing liability.

Senator Dixon. And I ask you finally the one last question I've asked you in private as well, the question of limiting the accounts to one account per individual or corporate entity.

Now I'm beginning to read about the financial institutions being very concerned about this because they're now analyzing and saying man, if you limit it to one account, we're going to lose deposits to who laid the rail. And I had thought that I was originally getting responses from some of you that that's a pretty good idea, but I now sense the industry is coming back and saying, hey, that's a terrible idea, and I'd like to just one more time——

Chairman Seidman. Well, I will only say about that idea is, I think, it ought to be explored. It has been very difficult to predict and complicated implications. I think it carries with it great administrative burdens and we are studying that at this time with the Treasury but I would not like to give you a conclusion on that at this time because we haven't completed that.

Senator Dixon. I just want to say in conclusion, Mr. Chairman, I don't know when the Chairman is going to leave—I wish he wouldn't, he'll be a great loss to the Government. I think he's one of the exceptional people I've known in my decade out here on the Hill and I want to publicly laud him and congratulate him for what I consider to be an outstanding performance in public service.

Chairman Seidman. Thank you very much, Senator.

The Chairman. I might just say, before yielding to Senator Kassebaum—I was intending to do this later, this is an appropriate point:

We're going to go out of here at some point on recess. I don't know what your own personal timing plans are with respect to your job—I think most of us hope you'll stay a long time into the future——

Chairman Seidman. Thank you.

The CHAIRMAN. But I'd like to have an understanding with you that when you finally do leave this job, at or about that time I'd like to have you back as a witness so that we can have a review of just generally the lay of the land on these issues and what the future looks like, so that we're not within the constraint of a particular hearing on a particular subject.

And I just—I want to extend the invitation now and I'd love to get an acceptance now and then we'll set the date at an appropriate time.

Chairman SEIDMAN. I would be pleased to do that, Senator. Thank you.

The CHAIRMAN. Very good.

Senator Kassebaum.

Senator KASSEBAUM. Chairman Seidman, you might be glad if you don't have to come by and testify. But it will be a loss and I share those who have expressed that view and I think your testimony this morning is an example of the thoughtful analysis that you've always given.

I would just like to explore—and some of this has been touched on a bit—but that the atmosphere today in the country is one that perhaps makes it more difficult for us to move ahead in some of the financial modernization concepts that are terribly important that we do and that we achieve.

I think, regarding the savings and loan situation, it's not clearly understood in the country but there certainly is a growing fear that it reflects a lack of Government accountability, our own transgressions regarding it, and I wonder in a way if it isn't our financial Vietnam, that there's just incremental losses that are occurring and we can't seem to get on top of it.

I think in answer to some of the questions that Senator Graham raised and others have raised, you believe that we're doing what we can do at this point—you've mentioned that we're adding supervisory personnel—but is there perhaps a more radical approach that we need to take to provide some means of bringing this erosion to an end?

Chairman SEIDMAN. I don't think there are going to be any miracles; this is a mistake that has been made and the costs are there. Maybe there are some ways—better ways that we can discover to contain the costs.

There are some things that we need—Senator Garn has a bill with regard to the environmental problems which is really vital to our going ahead with selling properties in the RTC and we certainly need that if we are going to contain costs, we need these provisions on golden parachutes which have become potentially very costly and caused us a lot of problems, and there are some other kinds of things that could be helpful that are in the Senator's bill.

But the environmental one, I would emphasize, is very important to us continuing to be able to sell real estate—and particularly large pieces of real estate—from the RTC and that's vital to holding the costs down.

Senator KASSEBAUM. Do you think that that, in and of itself, is holding back some of the progress in selling some of the larger——

Chairman SEIDMAN. There's no question that it is.

Senator **Kassebaum**. Well it's this kind of thing that I think we need to explore and we need to—if this is indeed that much of a factor, it seems to me, we need to try and get action taken as soon as possible.

Chairman **Seidman**. The only other thing I can suggest, Senator—and I don't know where this would come out, but I think we need to be very sure that we do not put more institutions into the RTC than we absolutely have to, because every time we put an institution in there it means financing more real estate on the market and so forth.

And I think we have to be very careful in looking at institutions that we keep that number as low as we can and still maintain sound institutions in the system. In other words, it may take longer for some institutions to recover but if that could be done without adding to the RTC's burdens, we might be able to contain the costs.

Again, it's too early for me to give an answer to that. We are making a study of that, we have talked with OTS about that; I think it's a subject that needs to be explored.

Senator **Kassebaum**. Because that is a decision that OTS makes as far as what institution is placed in——

Chairman **Seidman**. Yes. They ultimately make it although they make it with our concurrence because we have to accept them, but it's essentially something that we have been doing together.

Senator **Kassebaum**. Perhaps—do you feel they have been too anxious to do this fearing a potential loss and not giving enough time——

Chairman **Seidman**. Well I think they've been diligent in doing their job. It would be simply a change in terms of trying to look at situations to see whether, now that we know what we know, is there anything new that we know.

Senator **Kassebaum**. Thank you very much.

Senator **Garn**. Will the Senator yield before you give back your time——

Senator **Kassebaum**. Yes.

Senator **Garn** [continuing]. On the issue of my bill.

Because I want to emphasize what Mr. Seidman said about the importance of that bill. The difficulty we have in getting prompt action—as you may or may not have seen a recent letter that came out last week signed by 8 or 10 heads of all the major environmental groups.

And I was really distressed to see it, because these are good, responsible groups. I think the heads of those organizations ought to be embarrassed to sign such an inflammatory and also distorted and misleading description of what the bill does.

It is very narrowly constructed to exempt these financial institutions from blame or responsibility where they had nothing whatsoever to do with it other than to foreclose in bankruptcies and similar situations—and it talks about creating vast Love Canals all over the country.

So they've really mounted a major campaign against a bill that the man who is mostly responsible for getting us out of this problem says would be vital to that recovery and help save some money.

So I just wanted to highlight the fact that those who are responsible for this bail-out think it's vitally important and the environmentalists in this case are vastly exaggerating that bill and I think doing the country a great harm by not adequately and honestly addressing the bill.

Chairman SEIDMAN. I think it might be useful for us to get together with them and with the Chairman and some others and see if we can't get a better understanding of what it's about. Because it is a major factor—it is not just a small thing, it is a major factor in our being able to go forward with our job and particularly with the disposition of large properties, with these auctions and so forth.

And I'm sure that it—well I can't say I'm sure but it might be helpful to meet with some of these groups and see if we can't make it clear what it is that we're really talking about, because we're not polluting anything and, on the other hand, the taxpayers—there'll be less money for environmental clean-ups because this is going to cost more if we don't get it straightened out.

The CHAIRMAN. I thought there were meetings underway between yourselves and EPA—just leave the outside groups out of it for a minute—are those meetings taking place——

Chairman SEIDMAN. Yes.

The CHAIRMAN. Has there been a meeting of the minds in those discussions yet or not?

Chairman SEIDMAN. I'm not sure whether we have or not—does anyone know?

I don't believe so. I probably would have known by now.

The CHAIRMAN. I gather not. And so quite apart from the outside groups, my sense is that there's still some difference of opinion——

Chairman SEIDMAN. That's right.

The CHAIRMAN [continuing]. Within the Government and I think that's got to get sorted out quickly here, if it can be.

Now we're going to suspend for this vote—we're going to go over quickly and come back. We'd like you to remain.

Senator Sanford will start the questioning when we come back.

We've got a few additional items that I think are very important we need to discuss with you, so we'll come back just as quickly as we can.

The committee stands in recess for about 10 minutes.

[Recess.]

The CHAIRMAN. The committee will resume. And the questioning period now goes to Senator Sanford.

Senator SANFORD. Thank you very much.

Thank you for your testimony, which is excellent.

You answered Senator Bond's question about the size of banks and the area jurisdiction of banks, including the concept of nationwide interstate branching. You compared national banks with a grocery chain, but grocery chains don't get too big to fail.

Don't we have this whole concept of the moral hazard becoming even more of a hazard? Banks are getting to the point where unnecessary chances can be taken both because of deposit insurance and because of what is deemed to be a guaranteed policy of "too big to fail". I've always been worried about the "too big to fail" approach.

However, it seems to me that you can't answer the question about how big banks can get without relating it to the policy of "too big to fail." I'd like to have your comments on that moral hazard.

Chairman SEIDMAN. Too big to fail is something that we have to deal with. If we don't deal with that, we're not really dealing with the major safety net problem, if you will, because too big to fail is 100 percent deposit insurance for large institutions and, as I said in my testimony, I think we have to find a way to try to deal with that and I think we have to do it on an international basis. So that if we don't deal with that part of the problem, then many of the other things we're talking about here will simply not be very relevant.

Because if you look at the costs of the FDIC—the cost to the insurance fund of the FDIC, the large part of our losses have resulted from dealing with very large institutions where perhaps half of their accounts were insured. So we do have to deal with that problem.

I think, however, by making institutions national, they will have a much more diversified portfolio and therefore will be much less subject to having any one area bring them down.

Senator SANFORD. But if they're brought down, are you bringing down something of far greater cost to the taxpayers than simply paying off insured deposits?

Chairman SEIDMAN. Well that depends upon how you handle too big to fail and it depends on how well you supervise them. Hopefully the larger they are the more carefully we supervise them.

Senator SANFORD. Some of your testimony, of course, supplements how we might assure better supervision.

But isn't this pretty much the same thing? Few have said good words about the Blue Bonnet work-out arrangement. Maybe there's no good words that can be said about it. Isn't that extremely similar to the concept of "too big to fail"? Work-out arrangements like those in the 1988 deals are the opposite of failures where institutions are closed, depositors paid off and the resolution is complete.

Chairman SEIDMAN. Well the Blue Bonnet—all those institutions failed, they failed, but their depositors were protected, so to that extent it is——

Senator SANFORD. Obviously the depositors were protected, but they could have been protected by simply paying off depositors. Instead, we have put together this kind of an arrangement, in effect giving these insitutions to someone else to manage. Do you want to comment on the wisdom of that kind of an approach? These deals obviously were negotiated before you had anything to do with S&L's.

Chairman SEIDMAN. I would prefer not to comment on that particular situation because we are studying that at this time under the mandate of FIRREA and we will be reporting to the Congress in August; we have employed outside consultants and we are in that process right now and we will be reporting to the Congress——

Senator SANFORD. On the specific case of the 1988 deals?

Chairman SEIDMAN. On all of those transactions, that's correct.

Senator SANFORD. How much detail will your report explore in terms of the Blue Bonnet case?

Chairman SEIDMAN. There will be a detailed report on the transaction and the recommendations, if there are any ways in which we can reduce the cost of the transaction or any other recommendations that we would think the Congress ought to consider.

Senator SANFORD. Do you think that the extent of your investigation for this purpose of the annual report is adequate to arrive at all of the facts and possible lessons of that kind of an arrangement?

Chairman SEIDMAN. Well we intend it to be. We're mandated to do that by FIRREA. This is a separate investigation for which we have hired very well qualified outside consultants as well as using our own people and we will be looking at it to see what we can recommend both to save money with respect to those transactions and anything else that might be relevant to future legislation.

Senator SANFORD. When will this report be available?

Chairman SEIDMAN. We—by the end of August, I hope.

Senator SANFORD. I hope so too.

Chairman SEIDMAN. We intend to have it by the end of August, I should say.

Senator SANFORD. Let me change the subject——

The CHAIRMAN. Senator Sanford, if you would, just before you yield on that point, we have extended an invitation to have them come in and testify—and there's a long history on these 1988 deals in terms of tracking these things down and so we're working now to establish a date so that we can have a full presentation of the results of that work. And so once that date is set we'll announce it but the request has been made to set the date from the point of view of the committee.

Senator SANFORD. I am pleased that's going to happen, and I hope we can have it very early because, as you know, there are a great many Members of the Congress eager to look into these transactions.

It seems to me it's the jurisdiction of this committee to examine these deals. It's my understanding that we were not rushing to get into that revelation until we had the report called for in FIRREA. I certainly think the Banking Committee ought to take charge of looking at what went wrong as illustrative of what we might improve. This is a start for the committee's pursuit of acting on this important matter responsibly.

So I look forward to this Banking Committee's taking charge of the pursuit of those kinds of transactions, as well as changing the law or the regulations, or doing what else is needed to handle such case resolutions better in the future. So I hope the report is on time.

Chairman SEIDMAN. We have the chairman's letter and we will be reporting to the committee on our investigations in this area as soon as they're prepared.

Senator SANFORD. Since the chairman stole a minute of my——

The CHAIRMAN. I took it out of my time. Please, don't be deterred by that——

Senator SANFORD [continuing]. Time, let me change the subject.

I've been somewhat interested in Chairman Greenspan's suggestion of quicker intervention, which is quite appropriate, and greater capital for banks.

Do you think we need to go beyond the Basle risk-based capital requirements? A great many banks feel that this is not necessarily realistic. Do you have any comments on that?

Chairman SEIDMAN. I do think we have to go beyond that agreement—and the international supervisors themselves are preparing to go beyond that agreement by providing additional standards for interest rate risk, and then we need to go beyond that agreement perhaps in setting a base equity that has to be in place. And we are currently in agreement with the Fed on what they ought to be—but the Comptroller has not agreed with us—but I do think we need to put that in place.

I think additional capital is an important factor. I do not think that that is the sole answer to the problems we've been talking about by any means.

Senator SANFORD. Time is up. But let me say, Mr. Chairman, that I, too, am sorry to see Mr. Seidman leaving. Mr. Seidman has always been willing to speak honestly about the problems facing our banks and, and I regret that the administration appears to be encouraging him to go. Is there anything the Congress can do to keep you here?

Chairman SEIDMAN. Well I appreciate all the kind comments you've made. Maybe I just, you know, won't be able to resist that. [Laughter.]

The CHAIRMAN. Thank you, Senator Sanford.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Just to clarify your last answer—and it's an important question that Senator Sanford asked regarding higher capital and early intervention:

What I understand you to have said is that in principle you are for higher capital, but it should be the result of an international negotiation so that U.S. banks are not prejudiced in competition with other banks abroad; is that the sense of your comment?

Chairman SEIDMAN. In general that's true, although because we have a somewhat different system we may have to add some things to the international agreement. But in general I would like to see——

Senator HEINZ. You want to go beyond the Basle Accord.

Chairman SEIDMAN [continuing]. It for international competitors in our banking system be the same as other international banks.

Senator HEINZ. Are you also saying that if we cannot get an enhancement of the existing international agreement that we should not strengthen capital requirements on U.S. banks?

Chairman SEIDMAN. No, we would need to—if we don't get an interest rate risk factor in this capital requirements, we would need to put it in ourselves and we are in effect doing that now by putting a minimum equity capital requirement.

Senator HEINZ. You also indicated that there was some kind of disagreement between yourself and the Comptroller of the Currency, who will be testifying next. What is the nature of that disagreement?

Chairman **Seidman**. The basic disagreement is over what the minimum equity capital ought to be. His position is that it ought to be 3 percent. Our study shows that if that is the minimum capital requirement it would reduce capital requirements for about 90-some percent of all banks, primarily the small banks.

We have agreed with the Federal Reserve that 3 percent is only appropriate for what we call 1 banks or our highest rating banks and that any bank that doesn't have a 1 should be required to have at least 4 or 5 percent equity capital. So far, our position and the Federal Reserve's position has not been agreed to by the Comptroller, as far as I know.

Senator **Heinz**. I'd like to talk a little bit about what you believe the goal of the deposit insurance system ought to be. I believe the original goal—and maybe you still subscribe to it—is that it ought to protect the small depositor. Would you agree with that?

Chairman **Seidman**. That was one of the goals. The other goal was to make it possible to have a large number of small banks by giving them the ability to raise funds in competition with large institutions.

Senator **Heinz**. Looking at deposits, what is the average-sized deposit in the United States in banks?

Chairman **Seidman**. I think it's somewhere around $10,000 but I could give you probably something better than that.

Senator **Heinz**. What proportion of total deposits are insured?

Chairman **Seidman**. Probably about two-thirds, I would estimate.

Senator **Heinz**. What proportion of total insured deposits belong to the individual or small investor, as opposed to institutional?

Chairman **Seidman**. I don't know—I don't have the answer to that. I'll have to see if I can get that for you.

Senator **Heinz**. That, it seems to me, is a critical question. Because, either today or on other occasions, you've indicated that, you know, the small investor doesn't have the capability to make informed decisions about where he puts their money. But if you run a $1 billion money market fund, I would think it's not asking too much for a money market fund manager to make informed judgments about where they put their money.

My guesstimate is that a lot of the deposits that are insured in this country are institutional deposits.

Chairman **Seidman**. There is a very substantial amount of institutional, particularly money funds. And, of course, they have indicated that if the Government is not standing behind banks then a large part of that funding would go directly into government securities instead of into the banks.

Senator **Heinz**. And do you believe that that's possible?

Chairman **Seidman**. I believe that would happen, yes.

Senator **Heinz**. So you think any effort to limit deposit insurance to $100,000 per depositor would cause a flow of money out of banks?

Chairman **Seidman**. We are studying that right now and I can't give you an answer. It would obviously have an effect on small banks in terms of their deposits and I can only say that it is a very complex question and very hard to predict and we are working on that right now.

Senator **Heinz**. One of the issues that we are obviously, as you know, going to confront before we do any financial modernization is the whole issue of deposit insurance reform. I think every member of the committee believes that they've got to be handled at the same time.

If we don't come up with some more satisfactory answers than I think we have at the present time in terms of our present system, I think it will be very difficult to deal with any kind of financial modernization.

That really leads to an issue that many of us have tried to figure out over the years, and it is how to make sure that, as we expand bank access into other products in an effort to allow them to be competitive, to serve their customers, we insure that we don't transfer along with that unfair competitive advantages.

As you may know, the securities industry believes that the ability of banks to attract low-cost deposits, because of the deposit insurance, provides banks with an advantage. Do you agree that it does, in fact, confer a competitive advantage?

Chairman **Seidman**. I think it would if you did it that way. In my testimony, I suggest that they should not be allowed to use insured deposits to finance that or other new kinds of businesses that they become involved in, so that I would require that that part of the business be financed by the marketplace.

Senator **Heinz**. That leads to my next question I know you've testified that you support having separate capitalization for subsidiaries. What do you do with some of the activities that are kind of already across the line even if they're not banking?

I'm thinking of foreign exchange transactions that securities firms and banks now engage in. Should they be put in a separately capitalized subsidiary or should we let bygones be bygones?

Chairman **Seidman**. Well I don't think we should necessarily accept everything that banks do today as the kind of things that ought to be funded by insured deposits. I think that we ought to review that and move those things that are deemed to be high risk and in competition with other marketing organizations into separate entities which are not funded by insured deposits.

So, fundamentally, I don't think we should assume that everything that a bank does today should be funded by insured deposits.

Senator **Heinz**. You say that the standards that we should use to determine which should be an affiliate and which should be part of the insured bank should be high-risk. That's one standard you just enunciated; the other is competition with other financial services firms.

Two questions: are those sufficient criteria for us to make decisions? That is, if those were our two decision rules, would they be good enough? Second, are the criteria as they ought to be, for example, on the question of competition.

I mean, broadly speaking, everybody's in competition with everybody else when it comes to financial services. Would you care to elaborate on that at all, Bill?

Chairman **Seidman**. Well this is a very difficult question and a very important one if you agree with the concept. And I think that I can't give you a definitive answer, but those are the kinds of things that need to be considered.

I think diversification is another area that needs to be considered in this regard. And the fundamental principle will be to try to keep the safest and most traditional banking activities using insured funds, including the transfer system, and move the other kinds of activities out where they will use market funding.

Senator **Heinz**. Mr. Chairman, I know I'm out of time, and Mr. Seidman has clearly given this matter a great deal of thought. A good deal more discussion could take place on the subject.

What I'd like to do is submit to him several questions and a number of very specific "for instances" as to how he would rate along these two parameters these activities so that we get his views on the public record on an issue that we have attacked and approached and dealt with time and again.

Obviously he has a wealth of experience we'd like to tap in that regard.

The **Chairman**. Well, while you were out of the room, too, we covered that in a slightly different way. And that is that I extended an invitation to Mr. Seidman, Chairman Seidman, to come and meet with the full committee at the time in which he finally decides to leave his present position and that we would have a wide-ranging discussion at that time.

And it wouldn't exactly be an exit interview, but it would give us a chance to get into a whole series of reflections about where we are, what the future looks like, and to really draw on some of the storehouse of knowledge that he possesses, I think, quite uniquely.

So we will have that opportunity in addition to, I'm sure, his willingness to respond to questions that you submit for the record now.

Senator **Heinz**. Mr. Chairman, thank you.

The **Chairman**. Now let me get into a couple of things here. Am I right in understanding that when we take over a failed thrift right now and we end up transferring the assets in transferring the liabilities over to another organization, a successor organization, that we're going beyond the deposit insurance limits as I understand it. We're not just insuring deposits up to $100,000.

As I understand it, we're insuring, in effect, all deposits in transferring those over out of a failed thrift into a new thrift and protecting all depositors. Is that right?

Chairman **Seidman**. Well it depends on what kind of a transaction it is. In the first place, there are practically no uninsured deposits in thrifts?

The **Chairman**. You mean they've all been emptied out?

Chairman **Seidman**. They've all been emptied out. So, as a practical matter, we really don't face that very much except for very small amounts.

And, in general, when we transfer deposits, we can get a higher premium by not cutting people off. We transfer the whole thing.

The **Chairman**. So there would be some accounts that would go over——

Chairman **Seidman**. There could be.

The **Chairman** [continuing]. That would have balances of over $100,000 in a failed thrift——

Chairman **Seidman**. There could be under certain transaction.

The CHAIRMAN [continuing]. And, in effect, we're applying the insurance coverage to those amounts above $100,000. Would that be a fair summary?

Chairman SEIDMAN. In very small amounts in certain cases, yes.

The CHAIRMAN. So—that's interesting. Are we also finding—you're not saying by that that we're finding that, in thrifts that seem to be doing well, that there are not deposits well above $100,000?

Chairman SEIDMAN. Very few.

The CHAIRMAN. Even in the healthy thrifts?

Chairman SEIDMAN. Even in the healthy thrifts. There are more, but essentially they have insured deposits.

The CHAIRMAN. That's interesting. So then the broker deposits, the hot money, and so forth looks like it's pretty much cleared out of the industry. Is that a fair summary? Because wouldn't that tend to be——

Chairman SEIDMAN. I don't know, brokered——

The CHAIRMAN. Well maybe it would be if it's parceled out in pieces——

Chairman SEIDMAN [continuing]. Brokered deposits are insured money.

The CHAIRMAN [continuing]. That's right, I guess they would. I guess they would parcel them out in that sense, so you might still have brokered deposits out there——

Chairman SEIDMAN. Oh, yes.

The CHAIRMAN [continuing]. But they would be within the $100,000 insurance limits.

Chairman SEIDMAN. Yes.

The CHAIRMAN. Do we have a sense as to how much of that may be going on today, how many brokered deposits moving around?

Chairman SEIDMAN. We do. We have the numbers. We'd be happy to submit them to you.

The CHAIRMAN. It's fairly substantial?

Chairman SEIDMAN. Yes, it's a substantial amount, and it grows and goes up and down depending upon demands in various areas. We, of course, now have rules so they can't grow with brokered deposits so that there isn't the kind of abuses that we saw in terms of financing growth.

The CHAIRMAN. Is there any other power you need you don't have to clamp down on practices that you think shouldn't be going on today?

Chairman SEIDMAN. I think with the bills that you have before you, if those are passed in substantially the form we've seen—we have given a lot of very small suggestions for changing FIRREA, but I think essentially, if we can get the kind of thing that's in Senator Garn's bill and some of the other things that are in there beyond the environmental thing, that I don't have any major suggestion at this time.

The CHAIRMAN. Now is that another way of saying that FIRREA gave you the tools that you needed to do the crackdown and stop the abuses insofar as we were able to identify them?

Chairman SEIDMAN. I think so, with the exceptions of the bankruptcy laws where people—with the exceptions of golden parachutes, with the environmental liability, and a few others. We need some changes in the cross-guaranty laws to make them more viable. There are some things like that.

The **Chairman**. I just want to ask one more question on that subject, because we had lots of conversations when we were trying to get this bill written last year to make sure we stopped all the abuses.

Did we get them all insofar as you can tell today?

Chairman **Seidman**. Well I think you gave us, the supervisors and regulators, the power to be able to get the high-risk activities. There are still a lot of work that the supervisors have to do to use the powers to make sure that we don't get undue risk in the institutions.

The **Chairman**. Do you have enough supervisors?

Chairman **Seidman**. We're still building our force. We intend to build it over the next year, and I think by the time—by a year from now—we should be at the level that we need to be.

The **Chairman**. Are you being constrained at all by lack of resources?

Chairman **Seidman**. No.

The **Chairman**. It's just a matter of finding good people, hiring them, getting them trained——

Chairman **Seidman**. And training them.

The **Chairman**. And getting them——

Chairman **Seidman**. Yes.

The **Chairman**. So everything you feel you need to work with right now, you have? Is that a fair statement?

Chairman **Seidman**. I think we have the basic tools except for the things that I've just mentioned with regard to Senator Garn's bill.

The **Chairman**. But, in terms of personnel and your ability to get out and establish the regulatory and supervisory outreach, you feel that you've got the authority to do what you need to do.

Chairman **Seidman**. I believe we have the resources we need.

The **Chairman**. Now, let me ask you——

Senator **Garn**. Mr. Chairman, could I just follow up before we leave that point, because in our previous discussion about S. 2027, we only talked about the environmental part of it.

And what Mr. Seidman just alluded to, I think, is important and the need is there, too, in these other provisions, besides the environmental liability provisions. The branching rights of banks that acquire thrifts and want to operate them as branches, limitations on golden parachutes, giving the FDIC priority in banking bankruptcy suits, prohibitions on institutions indemnifying officers convicted of misdeeds, fraud, and so on.

So there are some other important provisions of that bill, and he mentioned there were without enumerating them, and I thought it might just be important to have on the record that this a bill that the FDIC says they badly need for these reasons.

Chairman **Seidman**. We certainly do.

The **Chairman**. Well we want to move on anything of things that we can identify that fall into that category.

It's my understanding that we've had a long delay, and perhaps it is not clear to me whether it's available as we sit here now or not, but I'm talking about the quarterly call data, call report data, for 1990. It has apparently very slow in being available.

And do you know if the first quarter's data is now out and publicly available or not?

Chairman SEIDMAN. I'm sure it is.

The CHAIRMAN. OK, well we——

Chairman SEIDMAN. I don't think we've had a problem that I'm aware of Mr. Chairman. Maybe on the S&L side——

The CHAIRMAN. It's usually——

Chairman SEIDMAN. I think they've had a problem, but I don't believe we've had any change from the past.

The CHAIRMAN. Well, we'll confirm that with you. Apparently, there's been some difficulty in getting hold of the March data. There's normally a lag anyway, and I don't know—what kind of a lag would we anticipate, both in terms of the March data and the mid-year data?

Chairman SEIDMAN. Well we use that data to put our statistics, which, as you know, we try to put out approximately 2½ months, 2 months after the data is made available to us. This note says that there has been some problem because the official tapes are being held up by the Federal Reserve Bank.

That's all I know. I didn't realize that.

The CHAIRMAN [continuing]. A problem somewhere. And, of course——

Chairman SEIDMAN. I'll look into it.

The CHAIRMAN. And that immediately sort of sets off the alarm lights around here when we can't get that data.

Chairman SEIDMAN. I do not know that there's a problem, but I will certainly look into it.

The CHAIRMAN. Fine. I appreciate that.

I want to try to clarify one other thing. We talked earlier about the question of how much money is needed by the RTC looking forward. And, of course, you testified on that yesterday, and it generated a lot of news attention today.

And we have been trying with these different cost definitions to juxtapose what you said yesterday with what Brady said when he was here, and making the adjustments for terminology, and what I think I heard you say today, and it sounded to me when I try to net all that out, that the numbers are comparable.

Now, if they're not, I want to understand that, as well. But it sounded to me—when he was here, he was talking about money being required in the range of $90 to $130 billion, which you've referred to today. And that if you subtract the $50 billion that FIRREA originally provided, that would be a figure of about $40 to $80 billion, in terms of additional funding.

And so when we talk about this new $100 billion figure, when he used his number, he wasn't talking about the carrying cost, the financing cost into the future. If you put those on, then obviously the number gets larger.

But if you compare the same estimates that he was endeavoring to give and that you've given, it sounds to me like the two of you were talking about numbers that are roughly comparable. Am I correct in that or not?

Chairman SEIDMAN. That is correct, but when we start talking about $175 to $200 billion, that includes the cost of the 1988 deals, so that his $90 to $130 billion did not include that. So you have to add onto that the estimated cost of the 1988 deals, which is somewhere in the area of $50 billion, plus you have to add on the refinancing of the safe fund, which is another $10 to $15 billion.

So you have to add all of those up to get to the number that I have used occasionally, $175 to $200 billion.

The CHAIRMAN. Right.

Chairman SEIDMAN. That has all of those factors.

The CHAIRMAN. Yes, but with that understanding, if you peel those things off and you come back to what he was talking about, and that is this direct cash requirement looking forward here, that somewhere in the range of $90 to $130, and you were saying—I think I heard you say earlier—maybe 110 is somewhere where you think maybe that number ought to be put right now, bearing——

Chairman SEIDMAN. Well I was saying that I think we can see enough now to see that we need at least a hundred.

The CHAIRMAN. Yes. So I think there's been enough confusion, though, that I think it was easy to draw the conclusion that perhaps you were talking about a number totally out of the range of what he was speaking about, and that was not what you were doing, as I understand it.

Chairman SEIDMAN. That's correct, but I tried to make clear that the numbers I was talking about—so far, we've only been talking about losses. In addition to that, there's the working capital numbers, which I gave the committee, and which I estimated at $40 to $60 billion for next year.

That's additional——

The CHAIRMAN. Over and beyond.

Chairman SEIDMAN [continuing]. Which we, yes. Which we expect to get back.

The CHAIRMAN. Well it's so confusing. I gave a report not long ago which I shared with you to try to go through this and lay out these different definitional ways in which we try to add up these costs, but it's still very complicated to try to take and line them up so that we can track these estimates when they do change, when they do enlarge.

Chairman SEIDMAN. Well it's very difficult because people like the GAO then add on the interest cost for financing it. And, of course, you can come up with almost any number you want to if you make it a longer period of interest and a higher rate of interest, you can evolve into huge numbers, and it just depends on what assumptions you make.

The CHAIRMAN. I want to ask you one other question in that area, and then I'm going to give you some questions for the record, too. And, of course, we still have Mr. Clarke waiting to come and testify.

And that is this: when you look at this whole S&L problem out there and the clean-up effort that we're in the midst of and the legislation we've passed and the job that you're doing and to try to resolve these things and so forth, do you feel comfortable at this point that the law we have in place and what we're doing is essentially the right prescription for the problem here, or are you beginning to get an uneasy feeling that there's something more that needs to be done or that this problem has changed and some new dimension that we need to understand?

Are we on course in terms of resolving this thing in an orderly and sensible way in your view or is there something that we need to maybe take into account that we didn't see a year ago?

Chairman SEIDMAN. No, I think we are essentially getting on course. I mean, we're getting it up and getting it moving. I think the law that was passed essentially does what's necessary to move this along.

I think we need to take a mid-course correction check. We are trying to do that, and we will be recommending anything we come up with as a result of that, but I don't have anything to recommend at this point.

The CHAIRMAN. And in terms of how the complexion of this problem may have changed over time, I know it's hard to go back and to put yourself in the—necessarily—in the exact mind frame that you may have been in a year ago when this legislation was passed.

But we've now got a year under our belt, so to speak. And I'm wondering if you think that basically what has been applied as a solution to the problem is still by and large what's needed or if the intervening year has told us that, you know, for whatever the intentions were at the time, that this situation may not look the same today.

I mean, what's your view on that?

Chairman SEIDMAN. Well my view is that what was done was essentially the right thing to do, was workable. There are certain parts of it that if I had written it myself would be a little different. But, essentially, we all have that.

And I think we have a vehicle that can work. I think it's very important that we get on with this deposit insurance reform and the things that we've been talking about today, because, really, FIRREA was a first step——

The CHAIRMAN. Right.

Chairman SEIDMAN. In dealing with the immediate problem that we had, but unless we continue with some of these things, we may well face some additional, very substantial problems.

The CHAIRMAN. Well that's exactly why we built the requirement for those studies into the law, so that we would make sure that they got done. And now we've come down—you complete, in fact, the hearing schedule that we've planned, 13 hearings this year to lay the foundation for the changes in the system that go way beyond the S&L system so that we don't leave ourselves vulnerable to risks to insured deposits in the future in ways that, perhaps, are not fully understood.

So we're coming down that track, and we want to get ahead of the next problem. That's the whole idea is to take these recommendations that you've given us and others. And I've asked Brady just when he was in here last week to set this as an objective on the short list of the Bush administration for 1991 and see 1991 is a year in which we get this done, so that we get ahead of Europe 1992 and other things and that we don't find ourselves just being tumbled by future events.

If it doesn't go on the short list of objectives and get the full muscle of the administration behind it, it is very difficult to move these complicated bills through. We might get it done here. We've moved on it in the past in the Senate, but there's a divided jurisdiction question in the House.

And to really get the momentum behind it that it takes to make a major structural reform with the change in the regulatory structure and so forth, you've really got to have the administration and the Congress working in tandem. And if it's not up on that short list of priorities, it's very easy to get, you know, pushed off to the side.

So that's why I view what you're saying and the others are saying as so important, is getting this foundation in place so we can go ahead and get this job done so we can get in front of events and not just, you know, be cleaning up problems out of the past.

Senator Garn.

Senator GARN. Chairman, I have no more questions, just a couple of comments.

I would suggest in looking toward 1991 that people recall that there has been a consensus in the Senate for financial services modernization for a long number of years. We passed bills on financial restructuring as early as the Financial Institutions Act back in 1976. And the House killed it.

And the latest was Proxmire's bill in 1988, which was the most far-reaching of all that only had two votes against it in the Senate. Only two Senators said they were opposed to it, and the House refused to take a look at that.

So the problem is obviously going to be in the House, not in the Senate. I would make one comment about estimates and say to you, Chairman Seidman, that I have absolutely no doubt, having watched you all these years, of your sincerity in producing these estimates and the best estimate that as an accountant that you can come up with.

But, as I look back over the years, my gut tells me that it's not going to be enough. And I don't think you have to have much of a political gut to figure that out, because it's fun to look back at them. I can remember in many, many hearings talking about, "We spent so much time talking about the size of the problem. When are we going to talk about solutions?"

Hearing after hearing, in 1987, 1988, 1989, we would sit here and three-fourths of the hearing concentrated on the size of the problem. I can remember using the illustration, "Look, we've got a hemorrhage. Put a tourniquet on it. If it's too tight, loosen it. If it's too loose, tighten it."

But we didn't stop the flow because we argued so much about the size of the problem. I don't question the sincerity. Senator Graham likes to blame it all on Dan Wall, but at that period of time, and the facts are not in dispute, he did underestimate the size of the problem, but so did everybody else.

GAO dramatically underestimated it. Bert Ely was the most accurate, and he was way above everybody else in that timeframe, but still way under what it's turning out to be. So I want to be very clear. I don't, again, question the sincerity of your estimates, but I don't think anybody should be surprised if in 6 months we're back, and it's going to cost more.

I think it will. In fact, I advised the Treasury Department a couple of years ago. I said, "Why don't you give your best estimate and double it and come up and testify to that. And from a political standpoint, you'd be far better off to overestimate the size of the problem than to underestimate it."

"Well, these are our best estimates."

But that isn't the question. I believe you. You're doing the best job you can, but there's a factor here that just tells you it isn't going to be enough. So I wanted to make very clear I was not questioning your sincerity or the job your agency is doing on those estimates, but I'll be terribly surprised if $130 billion covers it.

Thank you, Mr. Chairman.

The **Chairman**. I want to finally say you were kind enough to bring me a copy of this book that you have just written called Productivity: the American Advantage. We won't do this like they do it on the Today Show, although I'll just show this cover to the camera over here. But I don't know if we should make this a part of the record or not, that we can increase the distribution of it.

Chairman **Seidman**. Just a personal gift, Mr. Chairman.

The **Chairman**. I appreciate it. Thank you very much, and thank you for your testimony today. And we'll have questions for you for the record.

Chairman **Seidman**. Thank you.

The **Chairman**. Very good.

Chairman **Seidman**. Pleased to answer them.

The **Chairman**. Let me now invite Comptroller Clarke, who I know is close by, to come into the room and we'll hear his testimony.

We're very pleased to have with us the Comptroller of the Currency, Robert Clarke. We've had one vote this morning, that's delayed us, and we've also had ten Senators participating at different points this morning, asking questions, and that always extends our session. So I appreciate your patience in waiting and we're very pleased to make your full statement a part of the record and we'd like——

Senator **Graham**. He's smart enough to know that most leave during lunch, so he won't have as long a session.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. **Clarke**. Thank you, Mr. Chairman, Senator Garn. I appreciate the opportunity to be here. The subjects being discussed are very important and I'm glad to see that the committee is taking a lot of time asking questions.

I'm here, as you know, to discuss the need to modernize the structure and regulation of financial services in the United States. Stated very simply, the present structure unnecessarily restricts the operating authority and geographic scope of operations of U.S. commercial banks. If these restrictions are not changed and changed promptly, the financial strength and, thus, the safety and soundness of the U.S. banking system are likely to erode. If these restrictions are not changed, U.S. banks face difficult prospects in the future, both at home and abroad.

Domestically, other often more-diversified financial service providers are likely to out-perform U.S. commercial banks because they can offer customers more services in more locations than can banks. At the same time, these and other providers will continue to compete strongly with commercial banks in those lines of business that are open to both bank and nonbank financial institutions. For example, General Motors Acceptance Corp. is now one of the largest originators of home mortgages. Merrill Lynch offers checking accounts and credit cards to its securities customers nationwide. Without changes in the structure and regulation of U.S. banking, we can expect a slow, steady decline in the industry's position at home.

Internationally, the future is even darker, given the greater structural flexibility that foreign financial institutions already enjoy and the continued progress toward financial market liberalization in Europe. This aspect of the issue isn't of importance only to banking. Given the support that U.S. banks offer American industry, it is of importance to our economy as a whole. I am particularly concerned that some of our laws unnecessarily impair the efficiency of capital markets and thereby raise the cost of capital for U.S. banks. Consequently, U.S. banks are put at a significant disadvantage in rapidly developing international markets and are discouraged from making the investments necessary to compete effectively for business overseas. Once our banks retreat from these developing markets, as many are doing now, they are likely to lose opportunities permanently. Again, to the extent that these restrictions reduce the competitiveness of U.S. financial institutions, they also reduce vital support for the development of U.S. industry around the world.

The written statement that I have submitted for the record discusses in detail the numerous issues involved in modernizing the American banking system, the benefits to be gained from a more integrated banking system, and supervisory and risk-management techniques that could be used in a more competitive banking environment. The statement also suggests how concerns raised by expanding bank powers can be addressed without exposing the insurance fund to risk. Rather than repeating that testimony, I would like in the remainder of my opening statement today to expand on the problems presented by the current structure as well as why, from the perspective of a bank supervisor, authorizing U.S. banking firms to offer a broader range of financial services, revising the limits on bank ownership, and removing barriers to interstate banking would aid us in our efforts to make sure that the banking system remains safe and sound.

First, let's look at how the lines separating different segments of the financial services market have become increasingly blurred.

One: the growth of the commercial paper market has enabled investment banks to provide credit to the corporate sector, a line of business that has been the traditional domain of commercial banks. Yet commercial banks are significantly limited in their participation in the commercial paper market.

Two: the nature of commercial lending has changed. Increasingly loans are being converted into securities, and securities firms are increasingly active in providing bridge loans to underwriting clients, the equivalent of short-term commercial financing.

Three: mortgage brokers, insurance companies and other financial institutions are competing to a far greater extent with savings and loan associations and commercial banks for mortgage originations. The entry of nontraditional lenders into housing finance has been facilitated by the development of a smoothly functioning secondary market for residential mortgages and by the creation of mortgage-backed securities, which enhance the liquidity of the secondary market.

And four: commercial banks face increased competition for household savings from a host of other providers, such as savings and loan associations, credit unions and money market mutual funds.

Clearly, the financial services business has changed. It has become more competitive. But, just as clearly, the U.S. banking system is locked in a static legal and regulatory structure that prevents it from responding to these changes by becoming more competitive itself. The Depression-era Glass-Steagall Act still prohibits commercial banks from underwriting, investing in or trading for their own account in corporate securities and from owning equity stakes in commercial firms. Further, the law severely limits the conditions under which banks may be affiliated with firms that engage in these activities. National banking statutes limit bank insurance underwriting and brokerage activities. And, the Bank Holding Company Act effectively prohibits significant ownership of banks by commercial firms. It also generally restricts the insurance activities of bank holding companies conducted through nonbank subsidiaries.

These restrictions are in sharp contrast to the practice in other industrialized countries, and the remaining geographic restrictions on U.S. banking, like the product restrictions discussed above, are also in sharp contrast to banking practices overseas. As we debate the merits of removing the geographic restrictions that remain, most European nations have already adopted full nationwide banking and branching, and within 2½ years unrestricted branching throughout the European community will become a reality.

I could fill the time remaining in my opening statement by simply listing the benefits that product and geographic diversification would bring to the U.S. banking system and to the consumers of its service—and that list is in my written testimony. But I believe it would be more helpful for me to discuss some real-world examples of the concrete benefits that have occurred, one, where banks have expanded geographically and, two, where commercial firms have for years owned depository institutions.

First, one observable benefit from interstate banking is that where it has already been authorized it has enabled banks to become less dependent on local sources of deposits and less vulnerable to local economic conditions. In Arizona, which has allowed interstate banking since 1986, a large number of national banks are now owned by out of State bank holding companies. As a result, banks that do business in Arizona have suffered less from the downturn in Arizona real estate than if they had not had access to more diversified parent banking firms. As a result, the impact of the downturn on Arizona banks was less severe than if they had been confined exclusively to the Arizona market.

Second, with respect to the ownership of financial institutions by commercial firms, I am concerned that we are passing up important sources of stable management and capital. The irony is that under current law it is all right for commercial firms to own some insured institutions but not others. Companies such as Sears and Ford and J.C. Penney, Gulf and Western, Textron and Household Finance, just to name a few, are able to own thrifts and nonbank banks but they can't own full service banks. The Bank Holding Company Act's prohibitions on the ownership of banks by commercial firms have the unintended effect of cutting commercial banks off from an important source of capital.

Some have argued the expanded competitive opportunities would threaten the safety of the banking system and the solvency of the Federal deposit insurance fund. But these arguments assume that new lines of business for banking firms would be funded with federally insured deposits, or would be supported by access to the Federal Reserve discount window, or that they would be inherently riskier than traditional banking activities, or even that they would inevitably be mismanaged. In my opinion, a less restrictive and more competitive system can be structured in a way—which is discussed in detail in my written statement—that requires equity and debt holders rather than depositors and taxpayers to bear whatever risks are associated with the new lines of business.

And further, for the part of a bank that continues to be covered by deposit insurance or the discount window, I am confident that bank supervisors have the tools to deal with bankers who take inappropriate risks, and we are always working to improve those tools. We do this principally by making sure that banks have a material amount of their shareholders' own equity capital at risk, by providing effective on-going supervision and by closing institutions when they become insolvent, all of which are discussed in my written statement.

[The complete prepared statement of Robert L. Clarke follows:]

SUMMARY OF STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY

The United States stands out among major industrialized countries in the degree of separation that it requires between commercial banking and other forms of financial intermediation. Extensive restrictions on banking powers and on geographic expansion reduce competition in financial markets, make it difficult for banks to adjust to a changing marketplace, reduce their opportunities for diversification, and perpetuate a less efficient system of capital distribution. As a result, U.S. banks are less efficient, face a higher cost of capital, and are weaker competitors than their more highly integrated foreign counterparts.

Restrictions imposed by current banking law and regulations also harm consumers, who have fewer choices in shopping for financial services, and pay more for them. They harm businesses that depend on banks for credit, and find their sources of credit shrinking. And they harm the economy as a whole, which suffers when the efficiency of capital markets declines.

While financial integration has the potential to improve the efficiency of the banking system, and of capital markets generally, integration must be accomplished in a manner that avoids extending the safety net provided by federal deposit insurance to nonbanking activities. This is essential because such an extension could eventually impose large costs on taxpayers, and because there is no valid public policy reason to extend the safety net beyond core banking functions.

The banking system can, however, enjoy the benefits of financial integration without exposing insured deposits to new risk. This can be accomplished by housing expanded powers in separately incorporated affiliates and limiting transactions between them and the bank.

By controlling transactions between the bank and its affiliates, bank regulators can provide the maximum benefits from financial integration consistent with the safety and soundness of the banking system. Corporate separateness would ensure that a bank could lose no more than its investment in its affiliate. Limits on exposure, properly set, would ensure that even the loss of that entire investment could not endanger the bank.

In order to protect the bank from risks associated with new powers and to limit the extension of the federal safety net, the corporate structure of the banking firm must insulate the bank from certain expanded powers. This insulation could be achieved through separately capitalized subsidiaries of the bank or through subsidiaries of a bank holding company. Any necessary firewalls could be applied to either type of subsidiary. As long as the corporate structure provided appropriate protection to bank safety and soundness, the choice could be left to the banking firm.

Insulating banks from risk is not the only reason to require banking companies to conduct certain activities in separate non-bank affiliates. Separation would ensure that any residual subsidies implicit in the pricing of federal safety net services would not give banking firms an unfair competitive advantage in non-banking markets. It would also ensure that the safety net was not inappropriately extended to activities for which it was not intended. Finally, separation would facilitate functional regulation of financial markets.

Current law provides sufficient controls to manage any conflicts of interest that could arise from expanded powers, such as abusive practices involving the use of bank or trust account funds to purchase securities underwritten by the bank's securities affiliate. Securities activities conducted in a bank subsidiary or holding company affiliate would be subject to the registration and disclosure and anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Additional protection would be provided by the laws governing breaches of fiduciary responsibility, and by the ability of parties injured by abusive securities practices to seek redress through civil proceedings.

Supervising banking firms that conduct expanded powers should not pose any difficulties for bank supervisory agencies. I am confident that bank supervisors have the tools to deal with bankers who take inappropriate risks with insured deposits. We do this principally by making sure that banks have enough of their shareholders' own equity capital at risk; by providing effective, ongoing supervision; and by closing institutions when they become insolvent. We are constantly working to improve these supervisory techniques, and other techniques may be suggested by the Treasury study of deposit insurance that I mentioned a moment ago.

If we fail to address these critical issues, the United States may find in a few years that it has lost its position as a premier global financial center. We need a comprehensive reexamination of the statutes responsible for the current fragmented state of our financial services industry.

One final point: the Committee's invitation letter raised questions concerning deposit insurance reform. The Office of the Comptroller of the Currency is participating in a comprehensive interagency study of the deposit insurance system that is being conducted by the Department of the Treasury pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Since that study is still in progress, I will not make any specific recommendations regarding deposit insurance. I look forward to the opportunity to discuss the study's findings once the work is completed.

For Release:
July 31, 1990, 10:00 a.m.

STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
of the
UNITED STATES SENATE
JULY 31, 1990

Mr. Chairman and members of the Committee, I am here today, as you requested, to discuss the need to modernize the structure and regulation of financial services in the United States.

In your letter of invitation, you asked about my thoughts on reforming the deposit insurance system. The Office of the Comptroller of the Currency is participating in a comprehensive interagency study of the deposit insurance system that is being conducted by the Department of the Treasury pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Since that study is still in progress, I will not make any specific recommendations regarding deposit insurance. I look forward to the opportunity to discuss the study's findings once the work is completed.

As Treasury Secretary Brady testified last week, financial services activities must be considered in the context of deposit insurance. The Treasury deposit insurance study will address this issue in detail. I do, however, have some general comments at this time.

My testimony today will discuss some of the restrictions imposed by federal law on competitive opportunities for banks, the benefits to be gained from a more integrated banking system, and supervisory and risk management techniques that could be used in a more competitive banking environment.

Stated very simply, the present structure unnecessarily restricts the operating authority and the geographical scope of operations of U.S. commercial banks. These restrictions stand in sharp contrast to the continued progress toward financial market liberalization in Europe. They need to be changed. And they need to be changed promptly.

If the U.S. banking system is to remain competitive in international markets and to provide effective support to U.S. industry, it is essential that banks not be encumbered with costly restrictions on their activities that are not needed to ensure the safety and soundness of the banking system or to protect bank customers. I am particularly concerned that some of our laws unnecessarily impair the efficiency of capital markets and thereby raise the cost of capital for U.S. banks. Consequently, U.S. banks are put at a significant disadvantage in rapidly developing international markets and are discouraged from making the investments necessary to compete effectively for business overseas. By reducing the global competitiveness of U.S. financial institutions, vital support for the development of U.S. industry around the world could be reduced; and, domestically, less competition could reduce the variety of services available to consumers and increase their cost.

The OCC supports initiatives to increase capital market efficiency by authorizing U.S. banking firms to offer a broader range of financial services and by removing barriers to interstate banking. Some have argued that expanded competitive opportunities would threaten the safety of the banking system and the solvency of the federal deposit insurance fund. This assumes that such activities would be funded with federally insured deposits or have access to the Federal Reserve System's discount window, and that they would be mismanaged or be inherently riskier than activities which have traditionally been conducted by banks. In my opinion, a less restrictive and more competitive system can be structured in a way that requires equity and debt holders, rather than depositors or taxpayers, to bear whatever risks are associated with the new activities, including the risk of mismanagement--a risk that is a possibility in any business enterprise.

For the part of a bank that continues to be protected by the federal safety net (deposit insurance or the Federal Reserve discount window), I am confident that bank supervisors have the tools to deal with bankers who take inappropriate risks with insured deposits. We do this principally by making sure that banks have enough of their shareholders' own equity capital at risk; by providing effective, ongoing supervision; and by closing institutions when they become insolvent. We are constantly working to improve these supervisory techniques, and other techniques may be suggested by the Treasury study of deposit insurance that I mentioned a moment ago.

RESTRICTIONS ON BANKING POWERS

Restrictions on Products

Many of the laws that shape our current financial system date back more than fifty years to a period in which the market for financial services was highly segmented. Financial institutions--commercial banks, investment banks, thrift institutions, and insurance companies--were highly differentiated in terms of the services that they offered to the public and the types of investments that they made. Indeed, some of the restrictions and prohibitions on national bank activities originated in the National Bank Act, which became law in 1864.

Over the years, the lines separating different segments of the market have become increasingly blurred:

- o Commercial banks face increased competition for household savings from a host of other providers, such as savings and loan associations, credit unions and money market mutual funds.
- o Savings and loan associations compete with commercial banks, mortgage brokers, insurance companies, and other financial institutions for mortgage originations. The entry of nontraditional lenders into housing finance has been facilitated by the development of a smoothly functioning secondary market for residential mortgages, and by the creation of mortgage-backed securities, which enhance the liquidity of the secondary market.
- o The nature of commercial lending has changed. Many major institutional lenders, including some commercial banks, have converted loans into securities; and securities firms are increasingly active in providing bridge loans to underwriting clients--the equivalent of short-term commercial bank financing.
- o The growth of the commercial paper market has enabled investment banks to provide credit to the corporate sector: a line of business that has been the traditional domain of commercial banks. Yet commercial banks are substantially restricted from participating in the commercial paper market.

This explosion of new products, made possible in large part by advances in information processing technology, has increased competition in the market for financial services, but the competitive opportunities have not been evenly distributed. While investment banks and other financial institutions have been able to make substantial inroads into many traditional banking services, commercial banks have been impeded from entering new markets by federal laws and regulations that restrict the financial products and services they are authorized to provide.

- o The Depression-era Glass-Steagall Act prohibits commercial banks from underwriting, investing in, or trading for their own account in corporate securities, and from owning equity stakes in commercial firms; and severely limits the conditions under which banks may be affiliated with firms that engage in these activities. Yet investment banking firms are allowed to own banks and to offer many products and services that compete directly with banks.
- o National banking statutes have been interpreted to limit bank insurance underwriting and brokerage

activities, yet companies engaged in insurance underwriting can own banks.

- The Bank Holding Company Act effectively prohibits significant ownership of banks by commercial firms, and also generally restricts the insurance activities of bank holding companies conducted through nonbank subsidiaries. Yet commercial firms can own thrift institutions without the same restrictions, and commercial firms can also own banks on a limited basis (so-called "non-banks").

These restrictions are in sharp contrast to the practice in other major industrialized countries, almost all of which permit, for example, a wide range of securities activities either within the bank itself or in a wholly-owned subsidiary of the bank. (Only Japan shares our degree of formal separation between commercial and investment banking--because the modern Japanese banking system was modelled directly after our own--and efforts are under way in Japan to remove these restrictions.) Several European countries also authorize banks to engage in insurance underwriting or to have ties to non-financial enterprises to a far greater extent than is allowed in the United States.

Restrictions on Geographic Expansion

Federal law also limits the authority of banks to expand geographically. Under the McFadden Act, national banks (with the approval of the Comptroller) may branch within a state only to the extent permitted to state banks in that state. National banks generally cannot branch across state lines; consequently, interstate banking rules require establishing separate banks in each state, with separate capital structures and management. And the Douglas amendment to the Bank Holding Company Act permits bank holding companies to acquire out-of-state banks only if the acquisition is explicitly authorized by the state in which the target of the acquisition is located.

Ironically, the McFadden Act, enacted in 1927, was originally intended to expand the geographic opportunities of national banks, to allow them to compete with the large branch systems permitted under state charters. Authority to branch within the home office city was granted by the Congress in 1927, following a Supreme Court decision upholding the prevailing view that national banks did not have the legal authority to branch. Authority for wider area branching (to the extent permissible for state banks) was added by the Banking Act of 1933, partly to facilitate the injection of new capital into the many banks that were failing during the Depression (a situation that parallels recent state legislation and federal policies liberalizing interstate operations by permitting the acquisition of out-of-state insolvent institutions).

In contrast, the Douglas Amendment, like the Bank Holding Company Act to which it was attached, was intended to protect small banks from competition from large--and, generally, out-of-state--financial conglomerates. Senator Douglas represented Illinois, then the largest unit-banking state.

Although their original motivation differed, both laws have had the effect of subjecting national banks to the same geographic limits on multi-office networks as state banks. Such restrictions reduce competition in local markets and make banks more vulnerable to local economic downturns.

As competition for the public's savings from other types of financial institutions has intensified, the disadvantages of such limitations on banking networks have become more apparent. Many states have therefore relaxed their restrictions on intrastate branching and interstate banking. Only two states (Montana and Colorado) still practice unit banking, and the majority now permit full statewide branching. Forty-four states now permit acquisitions by out-of-state banking companies. Some of these states have entered into regional compacts, many of which have provisions that will permit entry from any state on a reciprocal basis after a certain date. Other states permit entry from any state with virtually no restrictions.

While many banking firms have succeeded in building interstate banking networks through acquisitions of out-of-state banks, state and federal laws have prevented them from employing potentially more cost-effective direct branch networks. This prohibition is widely believed to have driven up the cost of banking services and to have imposed artificial impediments to consolidation in the financial services industry.

These geographic restrictions, like the product restrictions discussed above, are in sharp contrast with banking practices overseas. As we debate the merits of allowing banking firms to purchase out-of-state banks, most European countries have already adopted full nationwide branching, and this will be expanded to unrestricted branching throughout the European Community within two and a half years.

ADVANTAGES OF FINANCIAL INTEGRATION

Authorizing commercial banks to provide a broader range of financial services over a wider geographic territory would confer a variety of benefits on the consumers of financial services and the broader public.

Increased competition in financial services. Allowing banking firms to engage in securities or insurance activities (and allowing securities or insurance firms to obtain bank charters) would promote more vigorous and effective competition in each segment of the financial services market. Increased competition would benefit consumers (both depositors and borrowers) in several ways:

- By reducing the cost of financial services to consumers, as firms compete for business by lowering prices.
- By giving consumers a wider variety of financial services and instruments from which to choose.
- By inducing firms seeking a share of the market to develop specialized niches, resulting in more individualized service for consumers.

Satisfying customers. A system that enforces a rigid separation between commercial banking and other forms of financial intermediation can make it difficult for banks to retain customers, particularly in a rapidly evolving market in which many types of financial services are available elsewhere.

For example, many firms that once relied on traditional bank loans for their financing now find that they can raise money more cheaply by issuing commercial paper. Since Glass-Steagall restrictions limit the authority of banking firms to underwrite corporate securities, banks are unable to compete for these customers and are losing them to securities firms.

A more integrated system would provide greater flexibility for banks to adapt their product mix to the changing needs of their customers. Moreover, the interests of some customers may be best served by a mix of products that neither banks nor securities firms are currently authorized to offer together.

Product diversification. Financial integration would give banking firms additional opportunities to diversify their portfolios and income sources. Diversification into a broader range of financial products and services would enable a bank to achieve a target rate of return with more stable earnings and less risk of losses to uninsured depositors, investors, and the federal deposit insurer.

A more diversified bank would not necessarily take fewer risks. An apt analogy would be to automobile drivers who benefit from technology that improves gas mileage. Most drivers would elect to save money on gasoline, but some would also choose to take advantage of the lower cost of gasoline to own higher performance cars, since better gas mileage would make high-performance cars less expensive to operate. A few drivers might ultimately spend more on gasoline than before, but they would still have benefitted from the new technology: they would simply have chosen to take the improvement in performance rather than in dollars.

Similarly, while banks could use diversification to reduce portfolio risk, they could also take advantage of diversification to increase the rate of return on bank assets, since diversification reduces the risk penalty of pursuing higher returns. Some banks might end up with the same or even more portfolio risk than before, but their creditors and investors would still be better off, since they would be adequately compensated for the additional risk that the bank assumed on their behalf.

It is important to keep in mind, in this connection, that activities are not unsuitable for banks simply because they are risky. A large part of the economic value created by financial intermediaries such as commercial banks lies in their ability to assess and assume risk and, by pooling funds and diversifying investments, to bear that risk more cheaply than an individual investor could. The safety and soundness of the banking system is not threatened by these activities, as long as the risks assumed by banks are understood by bank managers, are diversified and hedged against to the extent possible, are adequately compensated, and are borne by creditors and equity investors rather than by the FDIC.

Geographic diversification. Broader branching and interstate banking authority would also increase opportunities for diversification. Geographic diversification, like product diversification, can improve the bank's risk/return tradeoff and lower its cost of capital.

These advantages are not merely theoretical: where interstate banking has been authorized, it has enabled banks to become less dependent on local sources of deposits and less vulnerable to local economic conditions. For example, in Arizona, which has allowed interstate banking since 1986, a large number of national banks are now owned by out-of-state bank holding companies. When the Arizona banking market deteriorated in the late 1980s, some of these parent firms injected badly needed capital into their Arizona operations. As a result, banks doing business in Arizona have probably suffered less from the downturn in the Arizona real estate market than if those banks did not have access to more diversified parent banking firms.

International competitiveness. To the extent that a more fully diversified bank is able to provide a better risk/return tradeoff, the bank should be able to raise capital more cheaply. Conversely, if investors perceive that Glass-Steagall and other restrictions prevent U.S. banks from diversifying more fully, and if investors conclude that U.S. banks are, as a consequence, more risky than they would otherwise be, the result would be to drive up the cost of capital faced by U.S. banking firms, placing them at a competitive disadvantage relative to more highly integrated foreign banks. This may provide a partial explanation for the limited success of many U.S. banks in overseas markets, and also for their loss of domestic market share to foreign competitors.

The Glass-Steagall Act also has a direct effect on the ability of U.S. banking firms to compete in overseas markets. Although the European Community may permit U.S. banks to underwrite securities in the post-1992 single European market, the Glass-Steagall Act will prevent U.S. banks from marketing those securities to their customers in the United States. European banks will be under no such restrictions in distributing securities to their customer base in Europe. The absence of a strong home-country distribution system will place U.S. banks at a disadvantage in competing for a share of the European securities market.

The Federal Reserve Board's Regulation K, which implements the International Banking Act of 1978, governs the overseas activities of U.S. banking firms. Regulation K limits the ability of U.S. banks to compete in overseas securities markets by restricting the size of the offerings they can underwrite. These restrictions prevent U.S. banks from participating in some transactions that are open to their European counterparts. We welcome the Federal Reserve Board's recent proposal to ease Regulation K's restrictions, and we will study the proposal carefully.

Reduced operating costs. While Federal Reserve Board orders and court decisions interpreting the Glass-Steagall Act have expanded the securities activities of banking firms in recent years, the Board has required that new securities activities be insulated from commercial banking activities by a series of "firewalls." Safeguards such as these are intended to protect the bank and the deposit insurer, but if the safeguards are more extensive than is necessary, they can inhibit cost-effective integration of the new business activities into banking firms.

Adopting a more integrated structure would permit banking firms to consolidate corporate structures, eliminating horizontal duplication of personnel and overhead costs; to use bank premises, data processing systems, mailings, and other non-interest expenses more cost-effectively; and to achieve greater economies in the joint advertising and marketing of different types of financial services.

Some of these cost savings would be passed on to consumers in the form of lower prices for banking services, and some would be retained in the form of higher bank profits. Banks that are more profitable have greater stability and strength and are better able to attract capital because they can offer more attractive returns.

Financial integration might also permit some consolidation and streamlining of the operations of the various U.S. financial regulatory agencies. Any such consolidation, in addition to reducing government expenditures, would tend to reduce the cost to banks of complying with government regulation. Sources of compliance savings could include a reduction in the number of written regulations with which banks must familiarize themselves, consolidation of reporting requirements, and consolidated and more cost-effective examinations.

Capital market efficiency. Restrictions on banking powers can impede the flow of deposits to the investments that represent their most productive use. Or, the deposits may end up being used for the optimal investments, but the process of financial intermediation may be more costly than is necessary. In either case, the social gains from financial intermediation are less than they would be in a more fully integrated financial system. Similarly, geographic restrictions on branching impede the flow of excess deposits from some regions of the country to other regions of the country where loan demand exceeds locally generated deposits.

The Bank Holding Company Act's prohibitions on the ownership of banks by commercial firms may also reduce capital market efficiency and have the unintended effect of cutting banks off from an important source of capital and depriving the banking system of an additional source of stability. When banks have liquidity problems, they currently must resort to measures such as seeking above-market rate deposits or borrowing from the discount window.

Parent commercial firms could be a source of liquidity for a bank, as they have been recently for securities firms that are owned by financial conglomerates, but few commercial firms would be willing to subject their entire enterprise to extensive regulatory oversight and to the limits that the Bank Holding Company Act places on business activities just so they could buy a bank. Thus, Sears is able to own a thrift because only the thrift, and not the parent company, is subject to regulation by the Office of Thrift Supervision. Sears would undoubtedly have balked at buying a bank, since Sears would then have been required to divest itself of its retailing business in order to comply with the limitations on permissible activities contained in the Bank Holding Company Act. Yet, in its ownership of Sears Savings Bank, Sears has been a source of capital and stable management.

RISKS POSED BY EXPANDED POWERS

While financial integration has the potential to improve the operating efficiency of banks, and of capital markets generally, it is appropriate to identify the associated risks and to provide a structure of supervision and regulation that deals appropriately with any such risks.

Such a structure should prevent the safety net provided by federal deposit insurance from being extended to nonbanking activities, both because such an extension could eventually impose large costs on taxpayers, and because there is no valid public policy reason to extend the safety net beyond core banking functions. It should also control the opportunities for conflicts of interest that can arise when a highly integrated financial services firm becomes involved in more than one aspect of the same transaction. Finally, it should ensure that competition in banking and other markets is not compromised by excessive concentration of economic power in a few large financial services conglomerates.

The Magnitude of Risk

Some have argued that expanded competitive opportunities for banks would introduce more risk into the banking system than exists under the present structure. Careful analysis suggests that this is not necessarily the case.

The primary new activities that are being considered for national banks--such as securities dealing and underwriting, insurance brokerage and underwriting, or other agency activities--involve some risks, as do most business ventures, but they are not intrinsically high-risk enterprises. Well-managed firms in each of these areas have remained in business for many years, successfully managing their business risks and delivering profits to their investors. There is no reason why these activities should suddenly become riskier because they are conducted under the auspices of a banking firm. As long as the safety net is not extended to them, there is no reason why they should threaten the safety and soundness of the banking system.

Securities underwriting, to take one example, is not necessarily as risky as businesses in which banks now engage, such as commercial lending. Securities underwriters typically serve as middlemen; their funds are not usually committed to an underwriting transaction unless an underwriting syndicate exists to purchase the securities, and the underwriter is exposed only in the event that the syndicate fails to perform. An underwriter typically is exposed for only a short period of time, if at all. In contrast, a commercial lender typically commits to provide funds for a longer term, thus bearing credit risk over a longer period of time, during which the fortunes of the borrower may change. Commercial lending can, therefore, involve greater risk to a bank than would the same extension of credit structured as an underwriting transaction.

Protecting Safety and Soundness

If, on the other hand, banks were permitted to fund certain expanded powers with insured deposits, thereby extending the safety net to these activities, substantial amounts of risk could be shifted to the federal deposit insurer, and, potentially, to taxpayers.

Not all expanded operating authorities raise this possibility. Brokerage of insurance, for example, as well as some other currently prohibited activities such as management of mutual funds composed of equity securities, involve the bank as an agent rather than as an owner, underwriter, or guarantor of assets. Since the customer, rather than the bank, bears the risk of any change in the assets' value, these activities pose relatively little risk to the bank. They can therefore be conducted in commercial banks without posing any threat to safety and soundness.

Other expanded powers could, however, pose more significant risks. One such example is casualty insurance underwriting. Under normal circumstances, the laws of probability ensure that only a small fraction of policies will generate claims, but for certain types of casualty insurance, a natural disaster could result in large claims by many or all of the underwriter's policyholders. If a bank were directly a large underwriter, the losses resulting from such an event could, unless the transactions were structured appropriately, be large enough to affect the capital of the bank or cause the bank to fail.

Insurance companies ordinarily protect themselves against large casualty losses by diversifying their underwriting portfolios, pooling risks with other underwriters, and purchasing private reinsurance. The ability to fund this activity with federally insured deposits would shift part of the underwriting risk to the FDIC and diminish a bank's incentive to make such prudent arrangements for risk-spreading.

It should be noted that not all types of insurance would pose significant underwriting risks. Many insurance products are quite similar to bank products; for example, there are few differences between financial guarantee insurance and standby letters of credit. Other forms of insurance, such as life insurance, historically have had predictable loss rates. Insurance activities such as these could safely be conducted in commercial banks or their subsidiaries.

Concerns about Conflicts of Interest

Combining a broad set of powers in a single financial institution could expand opportunities for practices that enrich some of the institution's customers--or the institution itself--at the expense of other customers. While this is a legitimate concern, I believe that current law provides sufficient controls to manage conflicts of interest that could arise from expanded powers.

Securities activities conducted in a bank subsidiary or holding company affiliate would be subject to the registration and disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 (which were enacted at about the same time as the Glass-Steagall Act). These requirements provide substantial safeguards against abuses in securities transactions. Additional protection is provided by the anti-fraud provisions of the 1933 and 1934 Acts, by the laws governing breaches of fiduciary responsibility, and by the ability of parties injured by abusive securities practices to seek redress through civil proceedings.

In addition, the Federal Reserve Board has required bank holding companies to comply with firewalls designed to control conflicts of interest that might arise from their securities activities. In some instances, however, there may be alternatives to the Board's firewalls that could provide sufficient protection more cheaply. For example, one of the Board's firewalls prohibits banks from marketing the products of their securities affiliates. A prohibition on marketing may be unnecessary, as long as the relationship between the firms and the risk characteristics of the products are adequately disclosed to the bank's customers.

Concerns about Market Concentration

It is sometimes claimed that expanded powers would enable a few giant financial services conglomerates to take over the market. In my opinion, the opposite result is more likely, since authorizing banking firms to deal in securities and most forms of insurance (and allowing investment banking and insurance firms to obtain bank charters) would _increase_ the number of firms competing in each segment of the market for financial services.

Economies of scale. Competition could suffer if there were substantial economies of scale in the production of financial services, but most studies of the financial services industry indicate that the minimum efficient scale is small relative to the size of existing firms. What is more to the point, if there were large economies of scale in banking, they would _already_ have enabled large banks to drive their smaller competitors out of business. The high degree of competition that we actually see in the banking market, with numerous small banks coexisting with much larger institutions, indicates that the market is naturally competitive. The combination of commercial and investment banking (or any other combination of currently separated powers) in a single firm should not give large banks any _new_ advantage in competing with smaller firms. Thus, while we can expect current trends in the consolidation of the banking market to continue, and perhaps even to accelerate as a consequence of greater competition resulting from financial integration, there is very little risk that expanded powers would enable a small number of firms to dominate the market.

Finally, if the unexpected occurred and integrated firms were able to exercise excessive market power, antitrust laws should be adequate to handle any problems that arise.

Unfair competitive advantage. It is also sometimes claimed that implicit subsidies in the pricing of such safety net services as federal deposit insurance and access to the discount window would give integrated banking firms an unfair competitive advantage that would enable them to drive other providers of financial services out of business. Such an outcome appears highly unlikely, for two reasons.

First, the general trend in recent years has been to eliminate subsidies from the pricing of safety net services:

- The Financial Institutions Reform, Recovery, and Enforcement Act raised deposit insurance premiums, and required that premiums be set in the future at levels that would maintain the fund's reserve ratio (the ratio of the fund balance to insured deposits), which implies unsubsidized pricing of deposit insurance.
- The Federal Reserve Board has been moving in the direction of pricing Fed Wire services--including daylight overdrafts--at full cost.
- Last-resort lending is generally unsubsidized, to the extent that the Federal Reserve Board has a policy of making discount window loans at interest rates that exceed the borrower's alternative cost of funds.

Second, even if some implicit subsidies were retained, they would be not be likely to enable commercial banks to drive other financial services firms out of the market. While some aspects of bank regulation may benefit banks, other aspects of regulation (such as the cost of supervision and reserve requirements) place them at a relative disadvantage. There is no evidence that the net effect of bank regulation is to give commercial banks a competitive advantage over other financial institutions in markets where they both compete.

MANAGING THE RISKS OF EXPANDED POWERS

The principal risk that must be addressed by policymakers is the risk to the solvency of individual banks; to taxpayers, who ultimately stand behind the deposit insurance system; and to the stability of the banking system as a whole. Concerns about excessive market concentration resulting from expanded powers do not appear warranted, while the potential for conflicts of interest is adequately controlled by existing statutory and regulatory safeguards.

It is not necessary to forego the stabilizing effect that broad-based deposit insurance has had on the banking system in order to enjoy the benefits of financial integration. Insured deposits can be insulated from risk by requiring that certain types of newly permitted business activities be conducted in separately incorporated affiliates funded with uninsured liabilities and externally generated capital.

Insulating banks from risk is not the only reason to require banking companies to conduct certain activities in separate nonbank affiliates. Separation would also ensure that any residual subsidies implicit in the pricing of federal safety net services will not give banking firms an unfair competitive advantage in non-banking markets--although, as noted previously, such anticompetitive effects would not be expected to be large in any event.

Furthermore, separation would ensure that the safety net was not inappropriately extended to activities for which it was not intended. The purpose of the safety net is closely linked to the special role that certain core banking functions (deposit-taking, operating the payments system, and maintaining reserves that are used to manage the money supply) play in the economy. There may be reasons--quite apart from the risk, cost, or effect on competition of doing so--to avoid extending the safety net to other activities that do not share these special characteristics.

Finally, separation would provide clear lines of demarcation between the areas of responsibility of federal financial regulatory agencies, such as the division of responsibilities between banking agencies and the Securities and Exchange Commission. This would facilitate functional regulation of financial markets, where appropriate.

Corporate Separateness and Firewalls

In a series of decisions issued since 1987 interpreting Section 20 of the Glass-Steagall Act, the Board of Governors of the Federal Reserve System has approved applications from bank holding companies to establish non-bank subsidiaries that underwrite and deal to a limited extent in certain bank-ineligible securities. To comply with the restriction of Section 20 that prevents banks from being affiliated with firms that are "engaged principally" in underwriting, the Board prohibits such affiliations if the revenues generated by "bank-ineligible" activities exceed a set percentage of the revenues of the Section 20 affiliate. The Board broadened the range of permissible activities in 1989 to include all corporate debt securities, with deferred authority to underwrite equity as well.

In its Section 20 orders, the Board imposed a number of firewalls intended to insulate banks from risk. These firewalls generally prohibit banks from extending credit to, selling assets to, purchasing assets from, or financing the purchase by third parties of securities underwritten by their Section 20 affiliates during the underwriting period and for a period of time thereafter; and the Board requires that any investment by a bank holding company in its Section 20 affiliate must be deducted from the holding company's regulatory capital.

These firewalls can be criticized for subjecting affiliated firms engaging in expanded powers to a more stringent standard than is applied to extensions of credit to unrelated firms, which may involve comparable risk. Bank regulators recognize that individual risky loans are not necessarily unsuitable for bank investment, providing the bank can achieve a sufficient degree of diversification. Consequently, rather than prohibiting all risky loans, regulators have traditionally set limits on the fraction of a bank's portfolio that may consist of loans to any one borrower.

The same approach could be applied to expanded powers. Instead of prohibiting a bank from lending to or investing in its expanded powers affiliates, the aggregate exposure of a bank to its affiliate--including "arms-length" extensions of credit to the affiliate and its customers, purchases of assets other than short-term government securities, and equity holdings in the affiliate--could be subject to limitations analogous to the current limits on loans to one borrower.

Because equity claims are subordinate to debt and therefore expose the bank to more risk, it might be appropriate to count equity holdings more heavily than lending in the exposure limits. For example, if the exposure limit were set at 10 percent of capital, and if equity were counted twice as heavily as lending, then a bank with capitalization of $1 billion could lend up to $100 million to its securities affiliate, or it could own up to $50 million of the equity of its affiliate, but not both. Or, it could have a mixture of debt and equity exposure to the affiliate that satisfied the limit, such as $80 million in lending and $10 million in equity.

The most appropriate approach to bank supervision under a revised system of bank powers would vary depending on the exact nature of the revised system. Generally, a banking structure based on exposure limits would not place any extraordinary demands on the supervisory functions of bank regulatory agencies. Limits on the aggregate credit exposures of banks to their expanded powers affiliates would have to be monitored and enforced, but this would not present unusual problems to supervisors already accustomed to enforcing limits on loans to one borrower or to related borrowers.

Using exposure limits to control interaffiliate transactions would provide the maximum benefits from financial integration consistent with safety and soundness of the banking system. Corporate separateness would ensure that a bank could lose no more than its book investment in its affiliate. Limits on exposure, properly set, would ensure that even the loss of that entire investment could not endanger the safety and soundness of the bank.

Corporate Structure

In order to protect the bank from risks associated with new powers and to limit the extension of the federal safety net, the corporate structure of the banking firm must insulate the bank from certain expanded powers. This insulation could be achieved through separately capitalized subsidiaries of the bank or through subsidiaries of a bank holding company. Any necessary firewalls could be applied to either type of subsidiary. For example, the Office of the Comptroller of the Currency sometimes imposes supervisory conditions on the approval of new activities to be carried out in operating subsidiaries of national banks, including application of the legal lending limit. As long as the corporate structure provided appropriate protection to bank safety and soundness, the choice could be left to the banking firm.

Bank Supervision

In order for the U.S. banking system to be safe, sound, and competitive, we must have well-diversified and profitable institutions and effective supervision to protect the system against excessive risk. Before speaking to the question of how expanded powers can be supervised, I think it is worth digressing for a moment to discuss how we supervise current banking activities.

We use three basic tools for controlling risk: capital standards, supervision and examination, and bank closure. In recent years, the OCC has made important improvements in all three areas.

Capital Standards. At the end of this year, the OCC, along with the Federal Reserve Board and the FDIC, will begin to implement risk-based capital standards. This will make banks more sensitive to the credit risks in their portfolios and to their off-balance sheet risks. It will also force them to give greater emphasis to equity capital. As a result, many of the largest banks will either have to raise more capital or reduce their balance sheet risk.

As we phase in these requirements, we are working to improve them further. As I have said to this Committee in the past, the eight percent minimum risk-based capital standard represents only a minimum standard; where appropriate, the OCC will require banks to have more capital than the minimum--as many banks already do today. Representatives from the OCC and the Federal Reserve System are now participating in working groups set up by the Bank for International Settlements in Basle, Switzerland to determine if interest rate risk and foreign exchange rate risk can be reflected in the risk-based capital guidelines. Once we have evaluated these risks--and considered other enhancements to risk-based capital requirements that we are exploring on our own--we will have a more accurate assessment of what the precise level of bank capital ultimately should be. But one thing is clear: we need to ensure that significant losses from bank failures are borne by equity and uninsured debt holders, not the FDIC. It is equally clear that we must avoid placing U.S. banks in a position that prevents them from being competitive with other financial services providers, domestic and foreign.

Supervision and Examination. Strong capital standards must be complemented by a strong supervisory system. One of the lessons of the savings and loan crisis is that the assets of depository institutions must be valued realistically. Looking the other way only leads to problems later on. Effective bank supervision serves as a check to ensure that asset valuations are in fact realistic.

Supervision involves a great deal of judgment, and devising objective measures of its effectiveness is difficult at best. Some observers of the industry try to measure the quality of bank supervision by the frequency with which examiners perform complete examinations at each bank. This has the effect of forcing supervisors to spend too much time on areas that do not represent significant threats to the safety and soundness of the banking system.

An efficient allocation of available examination resources is essential if the OCC is to fulfill its responsibilities as the primary supervisor for more than 4,100 national banks, including most of the nation's largest commercial banks. The OCC allocates supervisory resources based on an annual strategy established for each institution. These supervisory strategies are based on our evaluations of the level of risk that we see in each bank, and the level of risk that it presents to the national banking system as a whole.

Large national banks account for roughly 48 percent of total national bank assets and 29 percent of all assets in the banking system. They are complex institutions that play a crucial role in the nation's financial system. Because of their size and complexity, we maintain a full-time resident examination teams in each multinational bank to devise and carry out supervisory strategies.

The supervisory strategies for other banks are determined case-by-case, with the greatest resources focused on those banks where we see indications of potential problems. Our approach is not unlike that of the Internal Revenue Service, which directs more of its auditing resources at filers who fall into higher risk categories.

Another important aspect of effective bank supervision is trying to anticipate systemic credit problems. As an example, in 1988, the OCC spearheaded the efforts of the federal bank regulators to review loans involving highly leveraged transactions. Also, beginning in 1988, in response to a steady increase in the real estate loan portfolios of national banks, we began to warn bankers that local real estate markets in certain parts of the country were being overbuilt. For example, an OCC Advisory sent to the chief executive officers of all national banks in December of 1988 encouraged them to review their real estate lending policies and practices in light of softening real estate markets, and warned that high profits earned while the local economy was still growing could mask serious problems with the quality of internal underwriting controls. Unfortunately, our warnings about the softening real estate markets have come true in many parts of the country. And over the past year, our reviews of the real estate portfolios of a number of national banks have verified asset quality problems and weaknesses in management controls.

We have heard criticism that the OCC is over-reacting, but such comments resemble those made in the mid-1980s, when businessmen and public figures swept aside concerns about the commercial real estate portfolios of savings and loan institutions. One of my greatest frustrations as Comptroller is that I have been warning about real estate problems for several years, and now some people ask me why we did not warn them sooner.

At the same time, bankers should not respond to our warnings by cutting off credit to qualified borrowers. The OCC, working with officials from other bank regulatory agencies, has been taking constructive steps to deal with possible overreaction to market conditions and regulatory scrutiny. On May 10, Federal Reserve Board Chairman Greenspan, FDIC Chairman Seidman, and I met with officials of the American Bankers Association to allay fears among bankers that regulators would criticize prudent bank lending. In that meeting, we stressed that our actions were not meant to discourage banks from lending to credit-worthy borrowers. All of us expressed our belief that banks should continue to lend: that qualified borrowers do exist and that they represent important business opportunities. This is the message that I have been delivering throughout the country to bankers, businessmen, local leaders, members of Congress, and the press.

Bank Closure. The third and most potent supervisory tool at our disposal is the ability to close an institution when its capital is depleted. Last year, the OCC changed its closure regulation to make it possible to close banks earlier. We no longer include loan loss reserves in measuring a bank's capital solvency. This allows us to close an insolvent bank at the point when its equity capital is exhausted, and will significantly reduce the cost to the FDIC of resolving bank failures.

CONCLUSION

The U.S. banking system stands out among major industrialized countries in the degree of separation that it requires between commercial banking and other forms of financial intermediation. Our extensive restrictions on banking powers and on geographic expansion reduce competition in financial markets, make it difficult for banks to adjust to a changing marketplace, reduce their opportunities for diversification, and perpetuate a less efficient system of capital distribution. As a result, U.S. banks are less efficient, face a higher cost of capital, and are weaker competitors than their more highly integrated foreign counterparts.

Restrictions imposed by current banking law and regulations also harm consumers, who have fewer choices in shopping for financial services, and pay more for them; harm businesses that depend on banks for credit, and find their sources of credit shrinking; and harm the economy as a whole, which suffers when the efficiency of capital markets declines.

These restrictions can be relaxed without threatening the safety and soundness of the banking system. Housing expanded powers in separate incorporated affiliates and limiting transactions between them and their banking affiliates will allow banking companies to enjoy the benefits of financial integration without exposing insured deposits to new risk. Supervising banking companies structured in this way should not pose any new difficulties for bank supervisory agencies.

If we fail to address these critical issues, the United States may find in a few years that it has lost its position as a leader in the global financial system. This argues in favor of a comprehensive reexamination of the statutes responsible for the current fragmented state of our financial services industry.

The **Chairman**. I'm going to have to just interrupt you there—and not wanting to.

We're on the second bells of a vote and it's on campaign financing reform and both Senator Garn and I are going to have to leave in a minute or we'll miss the vote. Also, that will be followed by our respective party conference luncheons, which occur on Tuesday, where we both have roles that we must play today.

The bottom line of that is that, while we'd like to hear the rest of your oral statement, we're not going to be able to do it right now because we're going to have to recess in order to go there.

I'm going to give you a series of questions for the record. I think your statement that you've given us that you're delivering here is very direct in terms of responding to the questions that we were interested in having you express yourself on. But I'm going to ask that you respond to my questions for the record, those of Senator Garn and the other members that submit questions and we're going to have to leave it at that for today I think.

Mr. **Clarke**. That's fine, or I'll be glad to come back when you have another available time——

The **Chairman**. Well let us—I want to leave that option open. We may very well ask you to come back—I'm not going to do that today, but I may very well do that at a later point because I don't want to feel that we haven't gotten everything covered that we need to.

Mr. **Clarke**. All right.

The **Chairman**. Very good.

The committee stands in recess. Thank you.

[Whereupon, at 12:45 p.m., the committee meeting was adjourned.]

[Response to written questions follow:]

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

September 7, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear ~~Mr. Chairman~~ Don:

Enclosed are my answers to Senator Sanford's followup questions to my testimony before the Committee on July 31, 1990. The questions were enclosed with your letter of August 7, 1990.

Thank you for the opportunity to expand upon my testimony. I trust the Committee will find this material useful as it considers the important issue of how to ensure broader competition in the market for financial services.

Sincerely,

Robert L. Clarke
Comptroller of the Currency

Q.1. Do you think that repeal of the McFadden Act and the Douglas Amendment would facilitate more efficient operation by our banking organizations without adversely affecting the safety and soundness of the banking system?

A.1. Yes. The geographic limits on the activities of banks and bank holding companies imposed by the McFadden Act and the Douglas Amendment to the Bank Holding Company Act reduce competition in local markets and make banks more vulnerable to local economic downturns. Authorizing commercial banks to offer services over a wider geographic territory would confer a variety of benefits on the consumers of financial services. Additionally, relaxing these geographic restrictions would remove artificial impediments to consolidation in the financial services industry.

Expanding the opportunities for banks and bank holding companies to diversify geographically can improve an institution's risk/return tradeoff, lower its cost of capital, and make the institution stronger financially. Evidence shows that these advantages are not merely theoretical: where interstate banking has been authorized, it has enabled banks to become less dependent on local sources of deposits and less vulnerable to local economic conditions. For example, in Arizona, which has allowed interstate banking since 1986, a large number of national banks are now owned by out-of-state bank holding companies. When the Arizona banking market deteriorated in the late 1980s, some of these parent firms injected badly needed capital into their Arizona operations. That additional capital put those institutions in a better position to withstand the downturn in the Arizona real estate market than would have been the case if those banks did not have access to more diversified parent banking firms. Thus, if financial institutions respond to a relaxation of geographic restrictions on banking activities by expanding the diversification of their portfolios, the safety and soundness of the U.S. banking system should be enhanced.

Q.2. If, for example, we should find it infeasible to repeal the McFadden Act at this time, do you think we could help our banking industry operate more efficiently by at least permitting U.S. banking organizations that lawfully own banks in more than one State to consolidate their banks on an interstate basis without regard to state lines?

A.2. Although a measure such as the one you suggest would not go as far as I would prefer in relaxing geographic restrictions on banks, I would welcome any improvement in this area. However, to permit even this amount of consolidation we believe that the McFadden Act would need to be amended, or an exemption provided, if the resulting bank is to be a national bank. If the Congress is willing to entertain such changes to the McFadden Act, then I would urge it to consider broader relaxation or removal of all McFadden Act and Douglas Amendment restrictions.

Forty-four states now permit entry by out-of-state banking companies. Some of these states have entered into regional compacts, many of which have provisions that will permit entry from any state on a reciprocal basis after a certain date. Other states permit entry from any state with virtually no restrictions. In accordance with those state laws, however, bank holding companies must maintain separately chartered banks in the states they enter. Such limitations on how banks structure their business operations unnecessarily impede competition. Also, allowing banking organizations to consolidate their operations across state lines could lead to a more efficient corporate organization.

Q.3. Do you believe such a consolidation approach would permit banks to save costs without addressing the issue of additional bank powers?

A.3. I would support a consolidation approach; giving banks more flexibility to offer services over wider geographic areas would undoubtedly result in some cost-savings. However, I think additional changes are needed to provide U.S. banks the opportunity to improve their performance. Our goal should be to increase the efficiency with which financial services are delivered, and I do not think we should delay addressing the issue of additional bank powers.

As we debate the merits of allowing firms to purchase out-of-state banks, most European countries have already adopted full nationwide branching, and this will be expanded to unrestricted branching throughout the European Community within two and a half years. Similarly, with regard to bank activities, most other major industrialized countries allow their banks to offer a much broader array of services than current laws and regulations allow U.S. banks to offer.

Consumers and providers of financial services could benefit from a reduction in product and geographic restrictions on bank activities. I think it is essential for us to consider any measures that provide such improvement to our financial system without threatening its safety and soundness.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

October 22, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Mr. Chairman:

I am enclosing answers to the questions you and Senator Sanford submitted to Secretary Brady following the Committee's July 25, 1990, hearing on financial service developments in Japan and Europe and modernization of America's financial services industry.

We appreciate the opportunity to present the Administration's views on these issues.

Sincerely,

Bryce L. Harlow
Assistant Secretary
(Legislative Affairs)

Enclosure

Answers to Questions
From Senator Donald W. Riegle, Jr.

Q.1. Many people would argue that in the 1980s we saw a lapse of supervision at some of our financial services regulatory agencies. What specific steps do you think should be taken to improve supervision and examination in the future and why shouldn't those steps be taken before any consideration of the issue of additional bank powers?

A.1. The issues of supervision and examination of insured institutions and additional bank powers are integrated. The Administration will be taking a look at these issues as a part of its comprehensive study of the federal deposit insurance system, but we do not consider potential recommendations in these areas to be "contingent" upon one another.

For one thing, it must be recognized that the vast majority of insured depository institutions continue to be well operated and financially sound under current regulatory standards.

The most serious problems among insured institutions have been largely confined to the thrift industry, especially that segment of the industry chartered and regulated by the states (most notably, California and Texas). Congress has traditionally defined the relationship between federal regulatory agencies and the states and, appropriately, significant steps were taken in FIRREA to strengthen federal control over state-chartered, federally insured thrift institutions (including higher capital standards, restrictions on junk bond portfolios, and regulation by the OTS).

Nevertheless, we believe that enhanced supervision of insured institutions, such as annual on-site examinations, could make a significant contribution to the identification and control of risk. But no amount of supervision and examination by regulatory authorities will be foolproof if the owners and managers of insured depository institutions lack incentives to control risk taking. For this reason the Administration has long emphasized the need to build up the capital base of insured institutions. The greater the amount of invested capital, the lesser will be the inclination of insured institutions to assume unreasonable risks. Finally, we believe that riskier, non-traditional banking activities should be moved to or take place in separately capitalized subsidiaries or affiliates.

Q.2. In your statement on page 25 you point out "Our system now has three federal bank regulators; one thrift regulator; one credit union regulator; and 50 state regulators." Senator Proxmire when he was Chairman of the Committee introduced legislation to consolidate the bank regulatory agencies. You express a concern about "the inevitable turf fights that may occur regarding streamlining regulation and supervision of our financial regulatory agencies." But turf fights notwithstanding, what specific streamlining and consolidation do you believe should occur?

A.2. Specific recommendations regarding regulatory streamlining and consolidation must wait on the completion of the Administration's current study of the federal deposit insurance system and its related issues. Ultimately, changes in the regulatory structure for banks will be driven largely by the choices made with respect to the proper range of activities for banks and the organizational structure required of banks to engage in those activities.

Nevertheless, the Administration has made it clear that any reform of the regulatory structure must advance the principles of functional and uniform regulation as well as decrease the inefficiencies attendant to overlapping and duplicative regulatory responsibilities. For example, some progress along the lines intended has already been made in FIRREA, notably the separation of the federal thrift regulator from the thrift insurer, and the introduction of uniform capital standards for both thrifts and banks, among others.

Q.3. You stated on pages 2 and 3 of your prepared testimony that the Treasury Department plans to complete the comprehensive study of deposit insurance mandated by FIRREA by the end of the year and will present its conclusions and any legislative recommendations early in the next Congress.

How broad do you imagine the conclusions of that study will be? For example, do you now contemplate that Treasury's proposals to reform the deposit insurance system will encompass recommendations on structural and regulatory reform and geographic and product diversification?

A.3. The primary focus of the study will be deposit insurance and specific safety and soundness issues. But these issues are integrated with structure, regulation, and geographic and product diversification, and to that extent these other issues will be the subject of examination and recommendations in our study.

Q.4. Many of the witnesses who have appeared before this Committee in this year's series of hearings have suggested that the competitiveness of U.S. financial institutions is slipping and this is caused in part by a failure to modernize our system of regulation including the failure to remove certain product and geographic restrictions. The impression given is that our deposit insurance fund may be subject to more risks if we fail to modernize our banking system than it would be if we modernized in a sensible manner.

Do you agree with such an analysis? If so, why?

A.4. There is considerable merit to this analysis. As outlined in Treasury's formal submission to the Committee, the value (profitability) of the traditional banking franchise has eroded significantly over time as the competitiveness of U.S. banks both domestically and internationally has slipped. It cannot help but follow that a weakened commercial banking industry can only increase the risks to the deposit insurance fund backstopping the industry.

In all of this it is important to recognize that the banking industry has not been weakened by the risks that go along with "new" activities. Rather, the pressure for profits has driven banks to assume ever-greater risks within the confines of their traditional service powers, most notably loan activity in real estate and less developed countries. It is possible that, if appropriately capitalized and supervised, expanded activities would provide banks with the flexibility needed to maintain their profitability throughout interest rate and economic cycles. And to the extent the economic viability of the banking industry overall is strengthened, the risks to the federal deposit insurance fund, and the taxpayers, is reduced.

These issues will be examined in greater detail in the study.

Q.5. When Chairman Greenspan testified before this Committee on July 12 he said the Federal Reserve Board was now skeptical about the ability of strong firewalls to protect banks and the deposit insurance fund from the risks of new activities that he advocated banks be authorized to undertake. He stated that higher capital standards and better supervision were the means to protect the insurance fund from increased risks posed by such activities.

On July 19 when Chairman Breeden appeared before the Committee to recommend new activities for banks he strongly advocated the need for firewalls to prevent regulated entities from being stripped of capital or liquidity to prop up a failed parent.

What are your own views on the efficacy of firewalls as a means of safeguarding the insurance fund from new risks that giving new powers to insured institutions may raise?

A.5. Expanding the activities of insured institutions will require careful consideration of the major measures available to us that serve to contain risks to the institutions and protect the deposit insurance fund. An important means of risk containment is to require greater capital, as emphasized in our statement to the Committee. Firewalls imposed on insured institutions by external authorities are also an important means of risk containment. But excessively numerous and stringent firewalls can be self-defeating, effectively nullifying the would-be benefits of expanded activities. It may be that greater reliance on augmented capital can mean fewer firewalls, but a definitive statement to this effect is premature at this point.

This issue will be examined more closely in our study.

Q.6. You stated on page 25 of your prepared testimony that "the Treasury Department has long supported the concept that the primary regulation of financial activities should be by function rather than institution."

When Gerald Corrigan testified before us in May he agreed with the concept of functional regulation but then added "we must have a system of consolidated supervisory oversight of any company that has direct or indirect access to the safety net."

Do you agree with Mr. Corrigan on that point, and if not, why not?

A.6. We agree that functional regulation by itself is likely to be inadequate. Other mechanisms must be in place to prevent abuse of insured depositories by affiliated companies. Whether this requires holding company regulation like the current system or a different form of oversight is something we will address in the study.

Q.7. Mr. Peter Cooke, formerly of the Bank of England who was the official who Chaired the Basle Committee which developed the international standards for banks appeared before this Committee on June 20.

He told us that over the years the Bank of England has discouraged the ownership of banks by non-financial firms "because of the concerns that the bank may be treated as an in-house bank by a dominant parent in unacceptable ways (e.g., through requiring the channelling of depositor's funds in the bank to finance the parent's business.)"

At that same hearing, Mr. Chisholm of the Bank of Montreal told us that the Canadian Government has also opposed commercial/financial links because "a clear separation of the financial and commercial sectors provides stronger protection against self-dealing and conflicts of interest and a firmer foundation for the stability of the system."

What are your own views on removing current legal restrictions separating banking and general commerce?

A.7. The separation of commercial banking and general commerce is one of the more important issues under review in the deposit insurance study. Conclusions and/or recommendations in this regard will be reported at the completion of that study.

Answers to Questions
From Senator Terry Sanford

Q.1. Do you think that repeal of the McFadden Act and the Douglas Amendment would facilitate more efficient operation by our banking organizations without adversely affecting the safety and soundness of the banking system?

A.1. These actions could have considerable merit. While some degree of interstate banking via holding company acquisition is now permitted by all but four states, interstate branching remains largely prohibited (except for thrifts). The critical element in this debate is not to "rule-in" or "rule-out" any particular banking structure, but, rather, to permit the market to define the optimal arrangements for different institutions. This is the principle we start from. This in turn would help to stabilize bank profitability and liquidity, adding to the overall safety and soundness of the banking system.

Q.2. If, for example, we should find it infeasible to repeal the McFadden Act at this time, do you think we could help our banking industry operate more efficiently by at least permitting U.S. banking organizations that lawfully own banks in more than one state to consolidate their banks on an interstate basis without regard to state lines?

A.2. We generally favor greater flexibility for interstate banking activities. The best approach to be taken is a subject under consideration in our study of deposit insurance and financial market reform.

Q.3. Do you believe such a consolidation approach would permit banks to save costs without addressing the issue of additional bank powers?

A.3. While it would be desirable to have a comprehensive blueprint for geographic and product diversification, the benefits promised by these measures are not contingent upon one another.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

ALAN GREENSPAN

Q.1. In your testimony, at page 10, you observe that critics of imposing higher capital requirements on U.S. banks could argue that international competitors that only adhere to the minimum capital requirements in the Basle Accord would be given a competitive advantage. But you reply that banks with higher capital are better positioned to be successful in the international arena.

If this is so, have competitive market forces driven banks to raise capital above minimum levels?

A.1. The evidence is clear that the customers of wholesale banks operating domestically and internationally want to deal only with financially sound banks. Perceptions of financial strength are based on more than one factor but chief among them are: (1) a strong enough capital position to operate broadly and deeply across financial markets and to provide flexible and continuous customer support over the long run; (2) profitability to sustain that capital position; (3) technological and market expertise; and (4) customer perception of government support in times of duress. In some cases, the last has been particularly important in the past, although the Basle Capital Accord and competitive pressures have eroded the weight placed on such support by international customers.

Very few internationally competitive banks appear to have a strategy to operate at Basle Accord minimum capital levels. Indeed, as I noted in my testimony, many successful U.S. and foreign institutions today substantially exceed such standards. I interpret the evidence as indicating that, almost without exception, the most successful banks operating domestically and internationally have capital significantly above minimum levels, and that this result is most certainly a competitive reaction to market forces.

Q.2. Since the cost of capital for U.S. firms is higher than the cost of capital for our international competitors, aren't U.S. firms already at a competitive disadvantage without imposing higher capital requirements?

A.2. The concept of the cost of capital is reasonably well-understood in economic theory, but quantitative comparisons of the cost of capital facing firms in various countries are difficult because of the complex set of factors that enter into the calculations. A number of studies have attempted cross-national comparisons of the costs of capital for various projects but have not focused on banks specifically. Nonetheless, a frequent conclusion has been that U.S. firms faced higher capital costs than some foreign firms in the past. There is some evidence that such differences in capital costs, if any, are less pronounced now.

In any case, raising new capital will be neither easy nor cheap for U.S. banks. In the short-run, higher capital requirements for U.S. banks are likely to place foreign banks in somewhat better competitive positions. This would be true even if, as might be the case, the cost of capital to U.S. banks is no higher than it is for every other bank.

However, it would be short-sighted to overlook the urgent need to induce market-sensitive behavior by banks. Over the long run, our banks, to compete successfully, must be prepared to meet new opportunities and changing circumstances. Well-capitalized banks are best positioned to be successful in broadening the scope of their activities and in exploiting profit opportunities. Such organizations are perceived in the market as the most attractive counterparties for a large range of financial transactions.

Q.3. Raising capital should help protect the deposit insurance system, but as we learned from RAP accounting in the thrift industry, it is easy to raise capital by simply lowering accounting standards.

A number of witnesses had advocated the use of market value accounting to measure bank capital. Indeed, the Fed's early intervention proposal would seem to mandate a form of market value accounting.

Is market value accounting a good idea? If not, why not?

A.3. The problems in our financial system over the last several years have focused attention on the considerable differences that often have been found to exist between accounting and economic measures of the earnings and net worth of financial institutions. Market value accounting has been proposed by some as a way to narrow divergences between accounting and economic measures of income, assets, liabilities, and equity capital positions. This suggestion is primarily based on the view that the market values of assets and liabilities are more reflective of their true economic values than are the historical costs amounts generally reported in financial statements under generally accepted accounting principles (GAAP). Therefore, it is argued that the use of market value accounting might lead to more effective regulation and supervision of financial institutions and to the closure of problem institutions long before they would become insolvent on the basis of financial statements prepared under GAAP.

While this proposition is of theoretical interest, a number of concerns have been expressed regarding market value accounting that should be considered. First, market value accounting could result in more volatility in the reported financial condition and earnings of financial institutions, thus possibly making judgments by the regulatory agencies, as well as by investors and depositors, much more difficult. Second, market values do not exist for a large percentage of a financial institution's assets and liabilities and standards have not yet been developed for the estimation of reliable market values for these items. Third, financial statements prepared solely on a market value accounting basis would generally meet the needs of a very limited group of users -- those interested in the liquidation value of institutions -- while perhaps not being relevant to many other users. Fourth, the overall cost and reporting burden associated with market value accounting could be considerable, including the cost of verifying market value quotations and estimates during audits and supervisory examinations. Furthermore, because market value accounting can lead to a sudden change in asset values, concerns have been expressed that market value accounting might result in potentially adverse reactions by financial institutions, depositors, and investors affecting credit availability, financial stability, or the competitiveness of U.S. banking and thrift institutions.

In my view, these concerns should be thoroughly studied before dramatic moves toward market value accounting are made. The federal banking agencies are reviewing the use of market values in connection with the federal deposit insurance study mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). At the same time, the Financial Accounting Standards Board (FASB) is studying the need for greater use of market values in GAAP as part of a project to develop new comprehensive standards for all financial instruments. These studies should provide additional information regarding the appropriateness of market value accounting for purposes of bank regulation and financial reporting.

My testimony included a proposal for prompt corrective action. A key part of this proposal is the conduct of on-site examinations -- focusing on the quality of asset portfolios and off-balance sheet commitments -- at least annually, where it is not already in practice. This rigorous review would help ensure that the loan loss reserves are consistent with the quality of the portfolio. When they are not, the examiner would insist that additional reserves be created with an associated reduction in the earnings and equity capital of the bank. This would lead to a more timely review of the adequacy of loan loss reserves and in a more accurate measurement of capital positions. When the resultant capital position of the bank is not adequate and credible capital raising commitments are not met, the regulatory agency would promptly require such responses as lowered dividends, slower asset growth, divestiture of affiliates, and other corrective measures while an institution's capital position is still positive. Such a policy would not only deter banks from riskier lending practices, it would also minimize the ultimate resolution costs.

However, this is not a proposal for market value accounting. While the adjustment of recorded asset values for inherent credit losses can be accomplished through market value accounting, it can also be accomplished under existing GAAP. Timely, thorough on-site examinations focusing on asset quality, together with rigorous application of GAAP, should result in loan loss reserves that more accurately reflect the estimated credit losses inherent in loan portfolios and in more accurate reported capital positions. This would narrow divergences between accounting condition and economic measures of depository institutions' financial condition and performance, while avoiding the potential problems associated with market value accounting.

Q.4. At an earlier hearing on financial modernization, the investment company institute recommended that Congress create so-called "narrow banks" that limit the use of insured deposits to investments in safe, liquid securities. This approach is designed to substantially reduce the risk of loss to the Federal Deposit Insurance System and address concerns relating to the competitive inequality created by deposit insurance.

Your testimony suggests that narrow banks are not a good idea. Why?

A.4. If we were starting from scratch, the narrow bank concept has two attractive characteristics. The public's payments accounts and insured liquid assets would, in turn, be backed by a portfolio of liquid, high quality, short-term assets, reducing the subsidy from deposit insurance to virtually zero. Second, the narrow bank implies that customers of banks would more directly bear the cost of deposit services. Since the narrow banks' profits would reflect only a narrow spread between very low-risk assets and virtually riskless liabilities, it is likely that there would be explicit fees on checking accounts to cover the banks' total cost of payment services; the customers' opportunity cost of holding bank deposits also would presumably rise as the average portfolio yield of banks declined relative to those of today.

However, if we imposed this structure on the existing banking system, a substantial institutional change would be required, dramatically modifying the way the public obtains its payment services. The profitability of narrow banking would be very limited, since its risk would be virtually non-existent, and many small banks would thus likely find it impossible to continue to operate on the resultant very narrow interest rate margins or user fees. The public cost of checking services would rise sharply, presumably reflecting the full cost of the services since banks could no longer absorb as much of that cost as a way to fund higher yielding assets.

In addition, most of the credit demands now met at banks for households, businesses, states, and local governments would not result in assets that could be held at narrow banks. A substantial part of such credit demands would presumably be met by uninsured bank affiliates, financing their holdings of claims on these entities with the owners' capital and short- and long-term funding from the public. It is likely that only larger banking organizations would be able to enter this business, concentrating intermediated business and consumer credit flows. While it is true that such affiliates--with no safety net--would likely be more cautious lenders than banks, credit and maturity mismatch risks would not be eliminated. Difficulties could then, as I noted in my testimony, result in creditor runs that could be transferred to rival financing affiliates, similar to the process in earlier years among uninsured banks. That is why I said in my testimony that "...we might end up with the same set of challenges we face today, refocused on a different set of institutions."

Q.5. During our first hearing on financial modernization, the SIA concluded that state chartered depository institutions with federal deposit insurance should have no broader powers than federal law permits. However, the banking industry's representative noted that the states function as important "laboratories" for developing new products and services.

Data on resolutions in the thrift industry indicates that the present value cost of resolutions of state chartered thrifts in relation to the total cost of thrift industry resolutions was 66 percent in 1987, 75 percent in 1988 and 76 percent in 1989. The vast majority of the cost relating to state chartered thrifts was attributed to institutions in Texas and California. These two states had the most expansive thrift charters.

Do you support the dual banking system? If so, how do you keep experiments conducted at the state level from blowing up the insurance system at the federal level?

A.5. The Board very much supports the dual banking system. The public has benefitted from the innovation and experiments conducted at the state level. At the same time, we must be sensitive to a kind of "competition in laxity" in which states seek to attract business to their jurisdictions by authorizing risky activities not permitted to federal-chartered entities, with those entities continuing to have full access to the federal safety net. However, the agencies now have full authority to restrict any activity of a federally insured depository institution on safety and soundness grounds regardless of state law.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

November 7, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
  and Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Mr. Chairman:

I am enclosing answers to the questions Senator Sasser submitted to Secretary Brady following the committee's July 25, 1990, hearing before the Senate Banking, Housing, and Urban Affairs Committee.

We appreciate the opportunity to present the Administration's views on these issues.

Sincerely,

Bryce L. Harlow
Assistant Secretary
(Legislative Affairs)

Enclosure

Answers to Questions
From Senator Jim Sasser

Q.1. Please provide me with statistical data showing the rate paid on one-year Treasury bills, the average rate paid on one-year certificates of deposits by banks and savings and loan associations, and the average rate on 30-year mortgages charged by banks and savings and loan associations, for every year since 1970.

A.1. The following table lists the data for the interest rates requested. (Data for 6-month CDs and 6-month Treasury bills are also included because data for 1-year CDs are available only back to 1973.)

Year	6-month T-bills[1]	1-year T-bills[1]	6-month CDs[2]	1-year CDs[3]	mortgage yields[4]
1970	6.86	6.90	7.65	n.a.	8.38
1971	4.67	4.88	5.21	n.a.	7.69
1972	4.63	4.96	5.02	n.a.	7.53
1973	7.54	7.31	8.30	7.52	7.99
1974	8.35	8.18	9.97	8.98	9.00
1975	6.39	6.76	6.89	7.38	9.16
1976	5.50	5.87	5.62	6.18	9.08
1977	5.75	6.09	5.92	6.27	9.02
1978	7.99	8.34	8.61	8.74	9.56
1979	10.70	10.67	11.44	10.85	10.87
1980	12.39	12.05	12.99	12.52	12.86
1981	15.06	14.78	15.77	15.38	14.99
1982	11.96	12.28	12.57	12.87	15.33
1983	9.27	9.57	9.27	9.54	12.82
1984	10.46	10.89	10.68	10.82	12.48
1985	8.08	8.43	8.25	8.55	11.71
1986	6.30	6.46	6.51	6.50	10.26
1987	6.35	6.76	7.00	7.11	9.30
1988	7.27	7.65	7.90	7.85	9.29
1989	8.50	8.54	9.08	8.65	10.12
1990YTD[5]	8.15	8.20	8.37	8.06	10.09

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[1] Coupon equivalent yields. Source: U.S. Treasury.

[2] Federal Reserve Board.

[3] Bank of America.

[4] Effective rate for conventional mortgages on new and existing homes charged by banks and S&Ls. Source: Federal Housing Finance Board.

[5] Through June 1990.

Q.2. On page 16 of your testimony, you note that the "improvement in the international position of Japanese banks has occurred in spite of an inefficient and burdensome regulatory structure. The positive causes of this success include interest rate controls that affect the Japanese saver and provide lower cost funds..." Please elaborate on this statement.

A. What exactly are the controls that exist on deposits at Japanese banks?

A.2.(A). Roughly 40 percent of all deposits in Japanese banks are regulated. "Ordinary" deposits and "small" time deposits (less than 3 million yen, or roughly $23,000 using exchange rate of 130 yen to the dollar) are subject to interest rate ceilings authorized by the Ministry of Finance in accordance with the Temporary Interest Rate Adjustment Law (TIRAL) of 1947 (simplified in 1970).

Under TIRAL, which was designed to ensure financial stability in the post war period, the Ministry of Finance determines whether interest rate controls are necessary in light of economic conditions. Interest rate ceilings are then set, and may be periodically adjusted after changes to the Official Discount Rate, on a range of accounts by the Policy Board of the Bank of Japan, taking into consideration recommendations by the Interest Rate Adjustment Advisory Committee (composed of bankers, academics and representatives of major industrial sectors). The current rates for regulated bank deposits (effective September 17, 1990) are:

Type of Deposit	Percent Interest
Ordinary Deposits (sub-one-month)	2.08
Time Deposits	
3 months	4.08
6 months	5.33
1 year	6.08
2 years	6.33

Eight percent of total bank deposits are in the form of Money Market Certificates (or MMCs). These MMCs are partially regulated, since the interest rate paid on these instruments is determined by a formula linked to a market determined interest rate on an unregulated instrument, e.g., CDs and 10 year Japanese Government Bonds. The minimum denomination of MMCs is currently 3 million yen, or roughly $23,000.

It should also be noted that a large (roughly 30 percent) portion of individuals' savings is placed in regulated Postal Savings Accounts with rates comparable to those on bank deposits. However, these funds are deposited in the Ministry of Finance's

Trust Fund, for later public lending or investment, and thus do not compete directly for lending to private business.

The Ministry of Finance has the discretion to change or lift interest rate ceilings on bank deposits, without the need for legislation or approval of the Diet. MOF used this discretion in 1985 and subsequent years to introduce unregulated large scale deposits and CDs, to introduce MMCs (intended as an intermediate step toward full deregulation), and to lower the thresholds on these instruments.

Last July, MOF announced a plan to introduce a three year time-table for interest rate deregulation, beginning with a plan to introduce a new type of MMC, to lower the minimum denomination of MMCs from 3 million yen to 1 million yen on November 5, 1990, and from 1 million yen to 500,000 yen (roughly $3,800) by the Spring of 1991; and to reduce the minimum for market-determined time deposits, from 10 million yen to 3 million yen (roughly $23,000) by the Fall of 1991. A MOF Advisory Council is currently deliberating moves to deregulate so-called "ordinary" or "non-time" deposits (accounting for 20-25 percent of total deposits).

B. As a result of these controls, how much lower is the cost of funds at Japanese banks than at American banks?

A.2.(B). The controls on Japanese interest rates do result in a lower average cost of funds for Japanese banks than they would have in an uncontrolled market. However, the cost of funds to banks in Japan compared to the cost to banks in the United States depends on a wide range of factors, including savings and investment patterns, tax provisions, monetary and fiscal policies, inflation experiences and expectations, and the effect of stock market fluctuations on the return on equity capital. While it is widely believed that the cost of funds for Japanese banks has been lower than the cost for U.S. banks in the past, it is difficult to quantity this difference in any precise way.

C. Does this lower cost of funds have an effect on interest rates for mortgages in Japan?

A.2.(C). In a competitive lending market, access to deposits at artificially low interest rates should force Japanese banks to pass on these savings in the form of lower loan rates. Mortgage rates in Japan, therefore, are probably lower than they would be if deposits were fully deregulated (though perhaps higher than in a fully competitive lending market). The rise in lending rates (and margins) that has accompanied deposit deregulation supports this.

Q.3. Before 1980, during periods of very high interest rates savers often removed their funds from insured depository institutions to seek higher rates paid on uninsured instruments. However, once Regulation Q was repealed, savers were given the opportunity to receive market rates and be federally insured.

A. In the context of deposit insurance reform, would it make sense to reimpose controls on interest rates paid on federally-insured deposits as a way to limit the taxpayers liability?

A.3.(A). Interest rate controls as we had in the past were unsuccessful in controlling risk in the wake of new market innovations such as money market accounts. It would not be wise to go back to that system.

B. Do you think that it is appropriate for depositors to earn market rates on deposits at the same time they are insured up to $100,000 per account?

A.3.(B). This raises the fundamental question of appropriate pricing for deposit insurance and who should pay for it, the bank or its customers. We are exploring this issue in Treasury's deposit insurance study.

Q.4. I notice in your testimony that "the Japanese Ministry of Finance has been reconsidering the Japanese equivalent of Glass-Steagall." For a long time I have been hearing that the repeal of Article 65 is imminent.

A. What exactly is the status of Article 65?

A.4.(A). The Ministry of Finance is currently considering a relaxation of the division between banking and securities business, as embodied in Article 65 of the Securities Exchange Law. Two separate advisory committees -- one under the direction of the Banking Bureau and the other under the Securities Bureau -- have been charged with recommending alternative avenues for reform. Both groups appear to be moving in the direction of permitting limited bank entry into the securities business through subsidiaries. The European "universal" bank model has been effectively ruled out as an option.

B. What process would the Japanese have to go through to repeal Article 65?

C. How likely is this to occur since, as you note, the "rivalries between the [Japanese] banking and securities industries are intense?

A.4.(B) and (C). Although there seems to be the beginning of a consensus on the subsidiary model, many difficult questions remain to be addressed, including the scope of securities activities permitted to bank subsidiaries, the form of subsidiaries (single or multi function), and appropriate firewalls. Also yet to be decided is the quid pro quo offered securities firms to compensate them for increased competition from the banks. The Securities Bureau Advisory Committee suggests that securities firms be allowed (1) to engage in commercial and trust banking business through subsidiaries and (2) to conduct foreign exchange business.

Although the specific scenario for reform of the banking/securities division remains unclear, it is possible that if all goes smoothly, some form of restructuring might be introduced by the Spring of 1993. A joint committee, composed of both advisory councils, is expected to draft an outline for reform of the financial system by June 1991. If a consensus is reached, MOF amy then submit legislation to the Diet by the Spring of 1992, with reforms effective by early 1993.

The vested interests in the two financial sectors (banking and securities) are well watched by their respective government bureaus, and rivalry between the two sectors is far more intense than that in the U.S. Every deregulatory step is generally a compromise among financial players and among regulators.

Q.5. It seems that everyone favors eliminating our de facto policy of "too big to fail" but no one has a good idea of how to do it.

A. How could we let a major bank fail without affecting hundreds of smaller banks and the payment system, as well as worldwide confidence in our banking system?

A.5.(A). The proposition that some banks are "too big to fail" poses a serious policy dilemma. On the one hand, there is the concern that disposing of large banks with sizeable losses to uninsured depositors will erode confidence in the banking system, perhaps leading to destabilizing runs. On the other hand, there is the concern that if failed banks are disposed of in a manner that protects uninsured depositors from losses then essential private sector discipline on management performance will be removed and taxpayer exposure increased. This is a major issue in our current study.

Q.5.(B). What changes would have to be made to insure that a large bank can, in fact, fail?

A.5.(B). As mentioned above, we are addressing this question in our study of the federal deposit insurance system to be completed by year-end.

Q.6. In testimony recently before this committee, Chairman Greenspan made several references to the need to protect uninsured depositors of banks. In particular, he said "reforms designed to rely mainly on increased discipline by uninsured depositors raise serious stability concerns."

A. Do you share Chairman Greenspan's concerns?

Q.6.(A). We believe that the extent to which uninsured depositors must be protected in the event of bank failure is an issue requiring very close examination. The issue is the extent to which genuine systemic risk is involved and the extent to which that risk may be reduced without protecting uninsured depositors.

B. Are many of the uninsured depositors those that hold foreign deposits that are not assessed any premiums?

A.6.(B). At year-end 1989 total deposits at FDIC-insured commercial banks amounted to about $2.540 trillion, of which some 26 per cent (or $667 billion) was uninsured. Foreign deposits of about $312 billion at year-end 1989 accounted for 46.7 per cent of all uninsured deposits.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

December 14, 1990

Dear Mr. Chairman:

Thank you for forwarding questions posed by Senators Garn, Heinz and Sanford following our July 31, 1990 testimony on modernizing the regulation of financial services. Enclosed is our response to those questions.

With best wishes.

Sincerely,

L Wm Seidman

L. William Seidman
Chairman

Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Enclosure

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

L. WILLIAM SEIDMAN

Q1. Since the passage of FIRREA last year, how much new capital has come into the thrift industry?

A.1 Prior to the first quarter of 1990, the Office of Thrift Supervision did not track the amount of new capital coming into the thrift industry. As a result of changes in thrift financial reporting, however, it is now possible to determine the amount of new capital in OTS-supervised institutions. From the end of the first quarter to the end of the second quarter 1990, new capital in OTS-supervised thrifts amounted to $519 million: $145 million from the issuance of perpetual preferred stock, and $374 million from the issuance of common stock.

It should be emphasized that the $519 million is a gross and not a net figure. Overall, the total equity capital of private sector SAIF-insured thrifts declined seven percent -- from $55.4 billion to $51.4 billion -- during June 30, 1989 through June 30, 1990.

Q2. Do you believe that anything should be done legislatively to enhance the flow of new capital into the thrift industry?

A.2 Altering or abandoning the Qualified Thrift Lender (QTL) test is one legislative change that might enhance the flow of capital to the thrift industry. FIRREA imposed a revised QTL test that will require savings associations to carry at least 70 percent of their portfolio assets in qualified investments by July 1, 1993. Interest rate risk in the thrift industry has always been high, and the QTL test only adds to the risk. The effect of the QTL test is to diminish the franchise value of thrifts.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

L. WILLIAM SEIDMAN

Q1. The composition of deposits in U.S. depository institutions is an important element in assessing the effect of various deposit insurance reform proposals. Please provide a stratification of deposits including:

a. Total domestic deposits in banks and thrifts;
b. The proportion of total deposits that are insured;
c. The average size deposit; and
d. The proportion of total insured deposits owned by individuals.

A1. a. As of June 30, 1990, domestic deposits were $2,477 trillion for BIF-insured commercial banks and savings banks. Private sector SAIF-insured thrifts had deposits of $785.4 billion, and savings associations in the RTC conservatorship program had deposits of $99.7 billion.

b. The proportion of total bank deposits that were BIF-insured was estimated to be 77 percent as of June 30, 1990. According to the OTS, about 97 percent of all SAIF deposits are insured.

c. As of June 30, 1990, the average size deposit in BIF-insured institutions was just over $8,100.

d. Deposit data for individuals only is not reported in the financial data collected from insured institutions. Only IPC deposits -- deposits of individuals, partnerships, and corporations combined -- is reported. The Federal Reserve conducts a monthly deposit data survey that collects demand deposit data (noninterest-bearing checking accounts) from a statistical sample of insured commercial banks. As of March 1990, survey respondents reported that 26 percent of total IPC deposits were held by consumers. As of the same date, the Federal Reserve weekly reporting banks reported that 23 percent of their IPC deposits were held by consumers. These data do not measure the portion of time and savings accounts held by individuals.

Q2. During your testimony, you stated that two relevant criteria in determining whether certain activities should be conducted within an insured institution or in a subsidiary or affiliate are (1) the riskiness of the activity, and (2) the extent to which non-insured institutions compete with insured institutions in conducting the activity.

a. What, if any, other criteria are relevant in making this determination?

b. List the current activities conducted by depository institutions. For each activity, apply the relevant criteria and identify which activities should be conducted within an insured institution and which should be conducted in a subsidiary or affiliate.

A2. As a general matter, the FDIC feels that insured banks should be limited to activities that are consistent with the traditional business of banking: issuing deposits and other relatively liquid claims, clearing payments and investing in short- and intermediate-term business and consumer loans. Activities that are not directly related to these activities or to the safe and sound operation of banks should be conducted in separately capitalized subsidiaries or affiliates that are not funded through the insured entity.

This view of defining permissible insured-bank activities depends on four basic propositions. First, banks contribute to economic prosperity by gathering funds from savers who seek liquid investments and lending to deficit economic agents that cannot issue liquid claims directly. In other words, banks create liquidity within the economic system by issuing claims that can be redeemed at par on short notice and originating and holding loans that, although of relatively short maturity, have no ready market. As a by-product of this intermediation function, some bank claims are used as money, and banks function as the primary private-sector participant in the payments and transfer system.

The second proposition is that the basic function as outlined above cannot be efficiently performed without an explicit or implicit backing by the government. The necessity of this backstop arises because of the nature of bank liabilities (callable at par on short notice) and assets (short-term maturities but not marketable at par). This liquidity mismatch, not maturity mismatch, is what creates both unique value from bank activities and the potential problems that require some form of third-party guarantee.

The third proposition is that activities that do not enhance the value-added to society of traditional banking activities should not be afforded the benefits of access to the federal deposit insurance safety net.

The fourth and final proposition is that, to protect the federal deposit insurance system, mechanisms must be in place that control the risks assumed by insured institutions, while not unduly hindering the positive effects banks have on economic stability and growth.

With respect to specific activities that are consistent with these propositions, clearly the general category of lending to businesses and consumers falls within the acceptable category. However, the dividing line between a prudent extension of credit and a *de facto* equity investment is not always clear. As a general rule, valid bank loans probably should be of a short or intermediate term, and should be made with recourse to the borrower's net worth. Firm take-out commitments should be required for loans supporting the beginning of long-term projects, and appropriate underwriting standards should be applied to all extensions of credit.

Holdings of investment securities is a valid function performed by insured institutions primarily to enhance liquidity and to take advantage of market opportunities. In some cases, especially in the municipal bond area, securities holdings are de facto loan transactions that should be viewed as loans. In relation to the propositions outlined above, readily marketable investments by banks generally should be confined to investment-grade issues and should be viewed as a means to satisfy liquidity contingencies; that is to say, other than for liquidity purposes, there appears to be no reason to provide deposit insurance coverage to fund readily marketable assets.

Banks also engage in underwriting of municipal and U.S. government securities. There appears to be no reason to support these activities by means of the safety net. Likewise, foreign exchange and securities trading activities more appropriately should be performed outside of the insured bank.

So-called off-balance-sheet activities need to be evaluated within the context of the four basic propositions. Standby letters of credit and similar arrangements likely belong within the permissible activities list, whereas interest rate swaps and similar arrangements need to be evaluated on a case-by-case basis, and accepted as a permissible activity if the transaction contributes to the safety and soundness of the bank.

The above represent general observations concerning the definition of permissible activities for insured banks. Whatever rules are adopted, a rule of reason would indicate that exceptions would be provided for situations in which the activities do not present a significant exposure to the deposit insurance fund, compliance would result in higher costs than benefits, and the convenience and needs of the community would be best served by allowing otherwise prohibited activities to be performed in an insured bank. Since these criteria most likely would be met in cases of small banks, it is suggested that it would be desirable to make separate rules for large and small banks.

Q3. SEC Chairman Breeden has suggested that the amount of federally insured deposits should be capped at a fixed amount in order to limit the financial exposure of the federal government from the deposit insurance program. Do you agree with this approach? If not, why not?

A3. A number of attractive proposals to limit the liability of the deposit insurance funds have been put forth. While the FDIC is in favor of limiting deposit insurance fund liability, it must be kept in mind that limiting fund liability would increase the exposure of depositors to loss. This in turn would likely increase instability within the banking system. This tradeoff should not prevent the adoption of desirable deposit insurance reforms, but it needs to be a consideration.

If Chairman Breeden is proposing an aggregate cap on insured deposits, there might be even more instability. The aggregate cap would prevent each depositor from knowing the extent of his insurance. Thus, the first signs of trouble in the banking system could precipitate a widespread rush to withdraw deposits.

Q4. SEC Chairman Breeden has suggested that depositors purchase deposit insurance so that each depositor can obtain the amount of coverage they need and ensure that deposit insurance is properly priced. Is this approach feasible? If so, what are the advantages and disadvantages of providing deposit insurance in much the same way as other insurance products?

A4. From an operational standpoint, the purchase of deposit insurance on an individual basis by depositors would entail considerable difficulties. Procedures would have to be devised to allow each depositor to make choices regarding the amount of coverage. The relatively simple revenue collection system now in existence -- whereby banks and thrifts pay assessments based on the aggregate amount of assessable deposits -- would be replaced by a much more complex system in which the depository institution funnels fees from individual depositors to the insurer.

A less cumbersome way to give depositors a choice regarding deposit insurance would simply be to allow banking organizations to offer both insured and uninsured accounts. The insured bank side of an organization would provide deposit alternatives covered by deposit insurance. An uninsured affiliate of the bank could offer investments, such as money market funds, not covered by deposit insurance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM

L. WILLIAM SEIDMAN

Q1. Do you think that repeal of the McFadden Act and the Douglas Amendment would facilitate more efficient operation by our banking organizations without adversely affecting the safety and soundness of the banking system?

A1. Yes. In fact, the McFadden Act and the Douglas Amendment, by hindering banks from diversifying geographically, reduce the safety and soundness of the banking system. The current laws place artificial constraints on banks that would otherwise be able to take advantage of technological innovations or market opportunities by expanding across state lines. The existing patchwork of regional compacts, reciprocity laws, and failing institution laws creates a situation in which bank expansion is governed more by legal loopholes than by market forces.

Beginning in 1992, European institutions will be able to grow unrestrained in a continental market. This process should result in the emergence of stronger organizations. Meanwhile, the growth of U.S. institutions will continue to be restricted by artificial barriers.

Q2. If, for example, we should find it infeasible to repeal the McFadden Act at this time, do you think we could help our banking industry operate more efficiently by at least permitting U.S. banking organizations that lawfully own banks in more than one State to consolidate their banks on an interstate basis without regard to state lines?

A2. This proposal has merit in providing some incremental cost savings to those institutions which would choose to consolidate operations. It might also have the beneficial effect of motivating states to increase the pace by which interstate barriers are removed. Nevertheless, the approach should not be seen as a solution to the fundamental problem. Banks would continue to be prevented from operating in a manner that, for many, would be the safest and most profitable -- nationwide.

Q3. Do you believe that such a consolidation approach would permit banks to save costs without addressing the issue of additional bank powers?

A3. This approach would enable some banks to save some costs. It is important for the continued health of the financial sector, however, that the issue of bank powers be addressed. The issue is an integral component of meaningful deposit insurance reform.

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